UNIT 11 ALL INDIA FINANCIAL INSTITUTIONS

Structure

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11.0 OBJECTIVES

After going through this Unit, you would be able to :

- Explain the meaning of Development Banking,
- State an overview of the Financial Institutions in India and their main activities,
- Describe the regulations over the Financial Institutions, and
- Discuss the performance of major Financial Institutions.

11.1 INTRODUCTION

A well-integrated structure of financial institutions has evolved in the country comprising 11 institutions at the national-level and 46 at the state-level. These institutions provide a variety of financial products and services to suit the varied needs of the corporates. The national-level institutions comprise *five All-India Development Banks (AIDBs), three Specialised Financial Institutions (SFIs) and 3 Investment Institutions (IIs). At the state-level, there are 18 State Financial Corporations (SFs) and 28 State Industrial Development Corporations (SIDCs).* The AIDBs are Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India Ltd. (IFCI), ICICI Ltd., Small Industries Development Bank of India (SIDBI) and Industrial Investment

Bank of India Ltd. (IIBI). The SFIs comprise Risk Capital and Technology Finance Corporation Ltd. (RCTC), ICICI Venture Ltd. (erstwhile TDICI Ltd.) and Tourism Finance Corporation of India Ltd. (TFCI). The Investment Institutions are Life Insurance Corporation of India (LIC), Unit Trust of India (UTI) and General Insurance Corporation of India (GIC).

IDBI, IFCI, ICICI, and IIBI provide financial assistance to medium and large industries, whereas SIDBI caters to the financial needs of small-scale sector. AIDBs also undertake promotional and developmental activities. Among the SFIs, RCTC and TDICI provide risk capital, venture capital and technology finance, mostly to start-up companies in the knowledge-based IT and related sectors. TFCI extends assistance to hotels and tourism-related projects. Among the investment institutions, LIC deals in life insurance business, while GIC provides general insurance cover. LIC and GIC deploy their funds in accordance with the Government guidelines. UTI mobilises savings of small investors through sale of units and channelises them into corporate investments mainly by way of secondary capital market operations. Besides, the investment institutions also extend assistance to industry through loans and by way of underwriting/direct subscription to equities and debentures. SFCs provide assistance mainly to small and medium enterprises, while SIDCs cater to medium and large-scale industries in their respective states. Apart from providing financial assistance, SFCs and SIDCs also undertake promotional and development activities.

Reserve Bank of India regulates and supervises All India Financial Institutions. These institutions are IDBI, ICICI Ltd., IFCI Ltd., IIBI Ltd., NABARD, NHB, Exim Bank, TFCI, SIDBI and IDFC. Reserve Bank of India undertakes on-site inspection of these institutions and has also evolved off-site surveillance system through obtaining periodic information.

11.2 DEVELOPMENT BANKING

Development Banks in India came into existence in the Post-Independence era. Prior to Independence, only commercial banks existed which provided the business community with short-term working capital finance The need, therefore, was felt for the establishment of institutions, which could provide medium to long-term finance to industry. The first development bank, set up in India in 1948, was the **Industrial Finance Corporation of India**. Its objective was *"to make medium and long-term credit more readily available to industrial concerns in India, particularly in circumstances where normal banking accommodation was inappropriate or recourse to capital issue method was impracticable."*

Development Banking differs from commercial banking in several ways. Commercial Banking is primarily concerned with short-term lending for financing working capital requirements of a concern. Development banking, on the other hand, is concerned with lending funds for medium to long-term for financing the investments in fixed assets of the company. Commercial banking is security-oriented, while development banking is project-oriented. Development banks also finance large-scale projects jointly with commercial banks. Developments Banks have recently been permitted to grant short-term working capital finance to the corporates. They have entered into various other types of financial activities and have undertaken various financial services as well.

Having discussed the important features of development banks, let us explain in brief the functioning of important development banks in India.

11.3 INDUSTRIAL DEVELOPMENT BANK OF INDIA (IDBI)

Industrial Development Bank of India is one of the four All India Development Banks in India. In addition, it is the apex banking institution in the field of long-term industrial finance and thus, it functions as the principal financial institution for co-ordinating the functions and the activities of other All India Financial Institutions.

IDBI was established in 1964 as a wholly owned subsidiary of the Reserve Bank of India (RBI). In February 1976, it was de-linked from the RBI and its entire share capital was transferred to the Central Government. In March, 1994, the **IDBI** Act was amended to empower **IDBI** to issue its equity capital to the public provided that holding of the Central Government does not fall below 51%. Subsequently, IDBI made its first public issue of equity in July 1995, which was the largest equity offering in the Indian stock market till then. The majority of its shares are still held by the Central Government, though the percentage holding of Government has declined to 72.14%.

As an apex developmental financial institution, **IDBI** provides both direct as well as indirect assistance to large and medium scale enterprises. Direct assistance by **IDBI** constitutes a major part of Bank's total assistance. Direct assistance is provided by way of Project Finance, underwriting and direct subscription to shares and debentures, guarantees for deferred Payments and Equipment Finance Schemes. **IDBI** provides indirect assistance through refinance of Term Loans and Re-discounting of Bills.

Besides the Equity Capital of Rs. 659 crores as on March

31, 1997, **IDBI** relies heavily on borrowings for its requirements of funds. Earlier, it used to borrow funds through Government guaranteed bonds, but of late, it has resorted to borrowings by way of unsecured bonds through public issues or private placement. **IDBI** has raised resources through issue of Certificates of Deposits as well. **IDBI** has been borrowing in the International Capital Markets to meet its requirement of foreign currency funds for the Indian industry. It has obtained lines of credit from multi-national agencies like Asian Development Bank, IBRD, Exim Bank of Japan besides lines of credit from German and French financial institutions. IDBI has also negotiated loans through floating rate notes in the international capital market at competitive rate of interests.

11.4 INDUSTRIAL FINANCE CORPORATION OF INDIA LIMITED

Industrial Finance Corporation of India (IFCI) was the first development bank established in India in the year 1948. It was established as a statutory corporation under the **IFCI** Act, 1948 with the objective of making medium and long-term funds more readily available to industrial concerns in India. **IFCI** was converted into public limited company on July 1, 1993 and is now known as the Industrial Finance Corporation of India Ltd. Every shareholder of **IFCI** became the shareholder of the company with effect from the date. The necessity for **IFCI's** conversion into a limited company was felt to ensure greater flexibility and ability of **IFCI** to respond to the needs of the changing financial system. After its conversion into a public limited company, **IFCI** now has the flexibility to reshape its business strategies with greater operational autonomy and in providing quality services to customers and tapping the capital markets. Under the **IFCI** Act, 1948, **IFCI** was prohibited to enter into the capital market except when backed by a Government guarantee and was thus prevented from raising resources on competitive basis. As a joint stock company **IFCI** is now able to enter the capital market for resources, through debt and equity instruments. After becoming a company, **IFCI** made a public issue of equity shares aggregating Rs. 525 crore during the year 1993-94.

11.5 INDUSTRIAL CREDIT AND INVESTMENT CORPORATION OF INDIA LIMITED

Industrial Credit and Investment Corporation of India Ltd. (ICICI) was the first development bank set-up as a joint stock company in India in 1955. Though Industrial Finance Corporation of India had already come into existence at that

time, necessity to establish another institution in the private sector was felt primarily to channelise the World Bank funds to the Indian industry and also to build up a capital market in India. Initially, its entire share capital was held by commercial banks and insurance companies and other financial institutions, but with the nationalisation of banks, major portion of its share capital was later held by these nationalised institutions. After the public cum-rights issue of equity capital by **ICICI** in 1991, the number of shareholders of the corporation increased considerably. As on March 31, 2001, its major shareholders were the Unit Trust of India (6.63%), Insurance Companies (23.47%), FIIs and NRIs (15.11%), Corporate Bodies (7.53%), Banks and Financial Institutions (3.11%), Individuals (10.21%). 32.65% of the shares were held by Deutsch Bank as depository for ADRs holders.

The core business activity of the **ICICI** has traditionally been the business of providing project finance. But over the years, it has undertaken many non-projects based activities and has diversified into new but allied activities through the establishment of its subsidiaries. For example, during recent years, **ICICI** has considerably increased the share of corporate lending from 9.1% in 1997 to 39.8% in 2001. Retail banking, i.e. lending for automobiles, homes, etc. now accounts for about 3% of its total loan portfolio. In project financing also, the share of infrastructure project finance has increased at the cost of manufacturing sector project finance, which has declined from 73% in 1997 to 35% in 2001.

Though **ICICI** had entered into varied and diversified financial services through its subsidiaries, a significant step was taken by **merging itself with its subsidiary ICICI Bank Ltd.** The merger became effective from March 30, 2002. Along with **ICICI** Ltd., two of its subsidiaries—**ICICI** Personal Finance Services and **ICICI** Capital were also merged with the Bank. Thus, **ICICI** Bank Ltd. has become the largest bank in the private sector with a balance sheet size of Rs. 104, 000 crore and capital adequacy of 11.44%.

Obviously, the apparent reason for the merger was to emerge as a Universal Bank, i.e. a bank which undertakes all types of banking and financial businesses. Probably, **ICICI** Ltd. realised that the days of specialisation into a specific line of activity (i.e. project finance) were over, as project financing ensures reward over a longer period of time, while commercial banking earns quick return and without much risk. The ICICI Bank Ltd., after merger will have to meet the requirements of Cash Reserve Ratio, Statutory Liquidity Ratio and priority sector lending on the entire liabilities of the merged entity.

Check Your Progress 1

1) Distinguish between Commercial Banking and Development Banking. Who regulates and supervises the development banks?

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2) What are the main functions of a Development Bank?

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3) What were the reasons for the merger of ICICI Ltd. with ICICI Bank Ltd?

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11.6 INDUSTRIAL INVESTMENT BANK OF INDIA LIMITED

Industrial Investment Bank of India **(IIBI)** was originally set-up as Industrial Reconstruction Bank of India under the Industrial Reconstruction Bank of India Act, 1984, as a principal credit and reconstruction agency for industrial revival by undertaking modernisation, expansion, re-organization, diversification or rationalisation of industry. However, with the establishment of the Board for Industrial and Financial Reconstruction **(BIFR)**, the role of **IRBI** as a principal agency for industrial reconstruction was marginalised. Hence, it was considered prudent to convert **IRBI** into a full-fledged all-purpose developmental financial institution. **IRBI** was converted into a Government company under the Companies Act, 1956 and was re-named as Industrial Investment Bank of India **(IIBI)**. This restructuring aims at providing adequate operational flexibility and functional autonomy to meet the challenges of the changing environment.

IIBI undertakes all the functions of a development bank. These functions include providing long/medium-term loan/ assistance to medium and large industrial units, and providing under-writing support to issuing of shares and bonds.

11.7 SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA (SIDBI)

Since its inception, the Industrial Development Bank of India functioned as the apex bank in the field of financing all industries including the small-scale industries. But when financing activities of small-scale industries grew significantly, need for a separate apex bank for small-scale industry was felt. The outcome was the establishment of Small Industries Development Bank of India (**SIDBI**), which took over IDBI's financing activities relating to small-scale industries.

SIDBI is the principal institution in the country for promotion, financing and development of industries in the tiny and small-scale sectors. It co-ordinates the functions of other institutions engaged in similar activities. SIDBI undertakes both financing activities as well as promotional activities and provides support services.

SIDBIs financing activities are broadly classified into two categories:

A) Direct Assistance, and

B) Indirect Assistance.

A) **Direct Assistance** : Direct assistance to small industries is provided in the following ways :

a) **Project Financing** : Project finance is provided for setting up of new units and for expansion/diversification/ modernisation/technology up-gradation of existing units.

b) **Equipment Finance Scheme** : Under this scheme, assistance is provided for expansion and modernisation of existing units.

c) **Technology Development and Modernisation Fund Scheme** : Technology Development and Modernisation Fund Scheme is a new scheme of **SIDBI** under which assistance is granted to units belonging to engineering, garments, electrical and electronics, crockery, pottery, etc.

d) **Bill Financing Scheme** : Bill finance accounts for the largest amount of direct assistance granted by **SIDBI**. Bills discounted fall in two categories:

- Direct discounting of usance bills arising out of sale of equipments by manufacturers of machinery/capital goods in the small sector. This enables them to offer deferred payment facilities to their prospective purchasers/users, and

- Direct discounting of short-term bills arising from sale of parts, components, sub-assemblies, accessories and intermediate manufactured by small-scale units and supplied to medium and large industries on credit. The aim of this scheme is to improve the liquidity and cash flow of small units as they receive prompt payment in respect of their supplies made to medium and large companies.

e) **Equity Assistance Scheme** : SIDBI provides equity assistance to different types of companies. It provides lines of credit to merchant bankers to put through bought out deals in respect of their small industrial unit clients. Assistance is provided to small units under National Equity Fund Scheme. Seed Capital is also provided under Mahila Udyam Nidhi Scheme and Scheme for Employment of Ex-Servicemen. Under the National Equity Fund assistance of Rs. 6.8 crore was provided to 730 entrepreneurs during 1995-96 as compared to Rs. 3.1 crore to 536 entrepreneurs during 1994-95.

f) **Venture Capital Assistance** : SIDBI also grants assistance from the Venture Capital Fund. SIDBI also subscribes to the funds of other Venture Capital Companies. The projects for which venture capital assistance is provided by SIDBI are in the high risks, specialised and import substitutive areas. Most of these projects propose to use indigenously developed technology and are promoted by experienced technical entrepreneurs.

B) **Indirect Assistance** : SIDBI grants indirect assistance to industries through

a) Refinance of term loans granted by Banks, State Finance Corporations (SFCs) and State Industrial Development Corporations (SIDCs), and

b) By Rediscounting of bills of small-scale industries.

11.8 NATIONAL BANK FOR AGRICULTURE AND RURAL DEVELOPMENT (NABARD)

National Bank for Agriculture and Rural Development (NABARD) is the apex financial institution in the area of agricultural finance and rural development. It was set up in July 1982 by merging the Agriculture Credit Department and Rural Planning and Credit cell of the Reserve Bank of India and the entire undertaking of Agriculture Refinance and Development Corporation.

NABARD undertakes the following functions:

i) **Credit to Farm Sector: NABARD** provides financial

assistance to the farm sector by way of refinance for various agriculture and allied activities, like minor irrigation, plantation and horticulture, land development, farm mechanisation, and animal husbandry. The refinance is provided to commercial banks, State Co-operative Banks, Regional Rural Banks and State Land Development Banks. Besides providing refinance, NABARD also provides short-term loans to State Co-operative Banks and Regional Rural Banks for financing seasonal agricultural operation, marketing of crops, purchase of agricultural inputs.

ii) **Developmental Activities**: NABARD undertakes various developmental activities such as formulation of credit plans, building of institutions, promotion of Research and Technology. It also co-ordinates rural credit agencies and develops expertise to deal with agriculture and rural problems.

iii) **Regulatory Function**: The Banking Regulation Act, 1949 has empowered NABARD to inspect the working of the Regional Rural Banks and Co-operative Banks. Its recommendation is required for opening of a new branch before the RBI gives its permission to do so.

11.9 NATIONAL HOUSING BANK (NHB)

National Housing Bank (**NHB**) was set up in July 1988 under the National Housing Bank Act, 1987 as the apex bank in the field of housing finance. It is a wholly owned subsidiary of the Reserve Bank of India. It is the principal agency to promote housing finance institutions at the regional and local levels and to provide financial and other support to such institutions.

NHB has an equity capital of Rs. 300 crores, which is contributed by Reserve Bank of India. NHB also raises resources through a variety of debt instruments such as bonds, debentures and borrowings. Its bonds which are guranteed by the Government of India, are eligible securities for commercial banks for compiling with the staturory liquidity requirement under Banking Regulation Act. Moreover, it receives external assistance also from the international agencies such as USAID, OECF Japan. It accepts deposits through Home Loan Accounts maintained by commercial banks.

National Housing Bank provides re-finance to the Housing Finance Companies, which are spread all over the country and account for the major share, followed by commercial banks and co-operative banks and Land Development Banks.

The eligibility criteria for obtaining refinance from NHB are as follows :

i) The housing finance company must have minimum share capital of Rs. 3 crore and the promoters' contribution of at least 25% of the total capital.

ii) It must be registered as a public limited company. Long-term finance for construction/purchase of houses for residential purposes must account for at least 75% of loans.

iii) It should not be a subsidiary of any construction company. Top management of Housing Finance Company should not hold similar office in Construction Company of the promoters.

National Housing Bank provides refinance to housing finance companies at varying rates depending on the size of the loans. The performance of NHB in terms of refinance provided by it to the Housing finance companies is given below :

Table 11.1 : Refinance provided by National Housing Bank

Year (1)	Disbursement by Housing Finance Companies (2) (Rs. in crores)	Refinance by NHB (3) (Rs. in crores)	(3) as %age of (2)
1990-91	953.9	N.A.	-
1991-92	1237.4	N.A.	-
1992-93	2395.4	N.A.	-
1993-94	2823.2	244.4	8.7%
1994-95	3524.3	275.6	7.8%
1995-96	4399.6	248.4	5.6%
1996-97	4618.7	327.7	7.1%

Source: Annual Report–National Housing Bank
NA = Not available

Thus, though the loans disbursed by Housing Finance Companies have increased by more than 5 times during the six-year period but refinance by NHB constitutes just 7% of the loans disbursed. Almost 90% of the housing loans given by the Housing Finance Companies are out of their own resources.

11.10 EXPORT-IMPORT BANK OF INDIA (EXIM BANK)

Export-Import Bank of India **(EXIM Bank)** was set up in 1982 for the purpose of financing, facilitating and promoting the foreign trade of India. **EXIM Bank** is wholly owned by

the Government of India. It is the apex financial institution in the country for co-ordinating the working of institutions engaged in financing exports and imports. Besides export finance, it also renders various advisory services to exporters and other entities connected with foreign trade.

EXIM Bank has a paid up capital of Rs. 500 crores, which has been contributed by the Government of India. Besides the equity capital, the Bank raises its resources from domestic and international markets, which constitute a significant source of funds. Within the country, its diversified resources base included bonds, fixed deposits, certificates of deposits, borrowings by way of term money. Banks, debt instruments have received 'AAA' ratings from CRISIL and ICRA. Exim Bank has raised foreign currency loans by way of medium-term syndicated loans from international banks. International Finance Corporation has granted it a Line of Credit. Similarly other overseas banks and institutions have sanctioned Import Lines of Credit under which foreign currency has been drawn by **Exim Bank**.

Exim Bank undertakes a variety of lending and service programmes, which are meant for Indian entities, Commercial Banks and Overseas entities. Exim Bank operates a wide variety of schemes for the benefit of Indian exporters. Some of these are as follows :

i) **Export (Supplier's) Credit** : Such credit is granted to Indian exporters to enable them to extend term credit to overseas importers of eligible Indian goods.

ii) **Finance for Consultancy and Technology Services** : Such credit is granted to Indian exporters of consultancy and technology services to enable them to extend term credit to overseas importers.

iii) **Pre-shipment Credit** : Such credit is granted to Indian exporters to enable them to buy raw materials and other inputs for export contracts extending over a period of six months.

iv) **Foreign Currency Pre-shipment Credit** : This is granted to eligible exporters to enable them to access finance for import of raw materials and other inputs needed for export production.

v) **Finance for Export Oriented Units and Units in Export Processing Zones** : This credit is granted to Indian Companies to acquire indigenous and imported machinery and other assets for export production.

vi) **Foreign Currency Lines of Credit for Imports** : Under this scheme, eligible export oriented units get foreign currency loans to acquire imported machinery for export production.

vii) **Overseas Investment Finance** : Such finance is provided to Indian promoters of joint ventures or subsidiary set up abroad. It enables them to finance equity contribution in such ventures. Exim Bank is one of the agencies to carry out technical appraisal to establish viability of overseas projects for approval by Govt./RBI.

viii) **Export Marketing Finance** : Such finance is provided to exporters to implement market development programmes and finance productive capabilities through loan financing. Companies can upgrade their production facilities and implement their strategic export market development plants to penetrate and sustain their presence in industrialised country markets.

ix) **Production Equipment Finance** : Under this scheme eligible export-oriented units are granted loans to acquire equipment.

x) **Programme for Financing Product/Process Quality Certification** : Under this programme, 50% of the.eligible expenditure incurred by corporates to obtain product/ process quality certification is reimbursed.

xi) **Export Vendor Development Finance** : This facility enables the vendors of export-oriented units to acquire plant and machinery and other assets for increasing export capability.

xii) **Export Product Development Finance** : This scheme is meant to enable Indian firms to undertake product development, Research and Development for exports.

Exim Bank provides finance/refinance to commercial banks in India/abroad to enable them to provide finance to Indian exporters/importers from India. These programmes are as follows :

i) **Refinance for Export (Suppliers) Credit** : Under this programme credit is granted by Exim Bank to banks in India to enable them to offer credit to Indian exporters of eligible goods who offer term credit over 180 days to their importers overseas.

ii) **Small Scale Industries Export Bills Re-discounting** : Under this scheme, banks can rediscount with Exim Bank export bills of their Small Scale Industries customers. The usance of the bills should not exceed 90 days.

iii) **Re-finance of Term Loans to Export Oriented Units** : Under this scheme, Exim Bank provides refinance to banks that offer credit to eligible export oriented units to acquire indigenous and imported machinery and other assets for export production.

iv) **Bulk Import Finance** : This scheme is meant to enable banks to offer finance to importers for bulk import of consumable inputs.

v) **Guarantee-cum-Refinance Suppliers Credit** : This scheme is meant to protect the cash flow of the banks and their exporter clients if the overseas buyer defaults. It protects the Bank by not treating the advances as non-performing asset for making provisions.

vi) **Programme for Confirmation of Letters of Credit** : Under this programme the ability of commercial banks in India is enhanced to open Letters of Credit on behalf of their importer customers for importing raw materials and other items.

vii) **Re-Lending Facility** : This facility is granted to the overseas banks. Under this facility, these banks are granted credit by Exim Bank to enable them to grant term finance to their clients for import of eligible Indian goods.

Exim Bank also operates schemes for the benefit of Overseas Entities (Importers/Institutional agencies in the Importers country), which are as follows :

i) **Lines of Credit** : Lines of credit are granted to financial institutions abroad, foreign governments, their agencies to enable them to grant term loans to finance import of eligible goods from India.

ii) **Buyers' Credit** : This scheme enables foreign buyers to import eligible goods from India on deferred credit terms.

As a complement to its financing programmes, **Exim Bank** offers a wide range of information, advisory and support services to Indian companies and foreign entities, which are as follows :

a) Market related information, assistance in evolving marketing strategies, undertaking sector and feasibility studies, and identification of technology supplies, partner search, investment facilitation and development of joint venture in India and abroad.

b) Advisory services, which enable exporters to evaluate international risks, assets and participate in trade and investment opportunities.

Check Your Progress 2

1) Explain the Equity Assistance Schemes and Venture Capital Assistance Scheme of the Small Industries Development Bank of India.

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2) Explain functions of NABARD.

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3) What is re-lending facility?

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4) State whether following statements are true or false:

   i) National Housing Bank provides refinance to the Housing Finance Companies at varying rates. (T/F)

   ii) NABARD is the Apex Financial Institution in the area of agriculture, finance and rural development. (T/F)

   iii) IRBI does not perform all functions of a development bank. (T/F)

11.11 REGULATION OVER FINANCIAL INSTITUTIONS

The Development Financial Institutions constitute an important segment of the Indian Financial System. They provide long-term funds for the development of industries, infrastructure projects and other major activities and thus, help in the growth of the economy. They are basically governed by their own statues and charters—Industrial Development Bank of India by the provisions of IDBI Act, 1964; and the Industrial Finance Corporation of India Ltd., the Industrial Credit and Investment Corporation Ltd. (ICICI) and the Industrial Investment Bank of India (IIBI) by their respective Memorandum of Association and Articles of Association, besides the Companies Act, 1956. Moreover, these financial institutions are also controlled by the regulations made by both the regulators of the Indian Financial System, namely the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI).

Section 45 L of the Reserve Bank of India Act, 1934, extends the supervisory authority of the Reserve Bank over the financial institutions. This section empowers the Reserve Bank of India to :

i) require the financial institutions to furnish to the Bank

information and particulars relating to their business, and

ii) give these institutions directions relating to the conduct of their business as financial institutions.

Vested with the aforesaid powers, Reserve Bank of India has exercised control over the financial institutions through directives or otherwise, as outlined below :

i) **Raising of Resources**

In the matter of raising of resources, financial institutions have to comply with the direction of the Reserve Bank of India, and the Securities and Exchange Board of India (SEBI). Till 1991, these institutions had access to cheap sources of funds—IDBI, along with Export-Import Bank of India and Industrial Investment Bank of India (IIBI) used to receive loans and advances out of the National Industrial Credit (Long Term Operations) Fund of the Reserve Bank of India. The bonds issued by them carried Government guarantee, making them eligible for being subscribed to by commercial banks to meet their statutory liquidity requirement. Both of these sources of raising finance at cheaper cost have been withdrawn since 1991. They are now allowed to raise resource from the capital market through bonds on market-determined terms and conditions without the patronage of government guarantee.

For raising the funds in the capital market through bonds, the financial institutions are required to seek the approval of the Reserve Bank of India. In addition, they have to comply with "Guidelines to Development Financial Institutions for Disclosure and Investor Protections" issued by SEBI in September 1992.

In May 1997, Reserve Bank of India replaced instrument-wise limits fixed for each financial institution with an umbrella limit (i.e. overall limit) for mobilisation of resource by way of term money borrowings, certificates of deposits, fixed deposits, Commercial Paper and inter-corporate deposits. The overall ceiling for the umbrella limit has been fixed at 100% of the net owned funds for each financial institution. Financial institutions are also permitted to accept fixed deposits for 1 to 5 years and issue certificates of deposits for a minimum amount of Rs. 10 lakhs. Rating for the term deposits accepted by financial institutions has been made mandatory effective from November 1st, 2000.

During 1997-78, Reserve Bank of India permitted these institutions to issue bonds with maturity of 5 years and above without its prior approval, but with simple registration with the Reserve Bank, provided the bonds are without options, etc., and carry interest rate not more than 200 basis points (one hundread basic points equal one percent)

above the yield on Government of India securities of equal residual maturity at the time of their issue. All other bond issues are required to be referred to the Reserve Bank for approval. In April 2000, Reserve Bank of India has decided to provide more freedom and flexibility to financial institutions in raising resources through bonds subject to overall limits fixed in terms of net owned funds. At present their total borrowings can be within the ceiling of 10 times of their net owned funds.

A copy of the offer document is to be submitted to SEBI. Lead Manager has to certify that this document is in conformity with the SEBI Guidelines.

ii) **Exposure Norms**

To minimise the risks in term lending, Reserve Bank of India has prescribed the exposure limits for term lending institutions (i.e. IDBI, ICICI, IIBI, Exim Bank and TFCI) and the refinancing institutions (i.e. SIDBI, NHB, and NABARD). Exposure ceiling has been linked to the institution's capital funds. Earlier it was not to exceed 25% of the paid up capital and free reserves in case of individual borrowers and 50% in case of group borrowers. Exposure includes funded and non-funded credit limits, underwriting and other commitments. With effect from September 1997, the group exposure limit was raised to 60% provided that the additional exposure related to infrastructure projects only. Moreover, exposure to any single industry has been prescribed at 15% of institution's loan portfolio. These exposure limits are applicable to Infrastructure Development Finance Company (IDFC) also. With effect form March 2002, the maximum exposure has been reduced to 15% for individual borrowers, 40% for group borrowers and additional 10% for financing infrastructure projects.

iii) **Lending Operations**

Though, the financial institutions enjoy autonomy as regards their lending operations, the Reserve Bank of India has intervened in the matter on a few occasions. It imposed a ban on financial institution on granting bridge loans against expected equity flows/issues, which was subsequently lifted on 23rd January, 1998. Recently, the development financial institutions have been permitted by the Reserve Bank of India to grant short-term loans to the corporates for working capital purposes. Reserve Bank of India has also permitted these institutions to fix their prime lending rates separately for short-term loans.

iv) **Prudential and Capital Adequacy Guidelines**

In March 1994, Reserve Bank of India prescribed prudential guidelines regarding capital adequacy, income recognition,

asset classification and provisioning for the term lending institutions. Subsequently these guidelines were extended to SIDBI, NABARD and National Housing Bank also. These guidelines are similar to those issued to the commercial banks, except for minor changes.

a) **Capital Adequacy Norm**

All India Financial Institutions were required to achieve capital adequacy norm of 8% by March 31, 1996. Capital adequacy norm has been expressed as a percentage of risk weighted assets. In December 1998, the minimum Capital Adequacy Norm for financial institutions, was enhanced to 9% to be effective from March 31, 2000. All the financial institutions except IFCI Ltd., have achieved this norm at the end of March, 2001. Capital funds are divided into two categories i.e. tier I and tier II capital on the pattern of norms for commercial banks.

b) **Income Recognition**

Financial institutions are allowed to treat an asset as non-performing asset (NPA) if interest/principal is overdue for more than 180 days with effect from March 31, 2002. In respect of NPAs the financial institutions should not take interest income, fees or any other charge, unless actually received.

c) **Asset Classification and Provisioning**

The basis of assets classification and provisioning for financial institutions is almost on the same lines, as prescribed for commercial banks.

11.12 PERFORMANCE OF MAJOR FINANCIAL INSTITUTIONS

The following table shows the disbursements by the three All-India Financial Institutions during recent years. ICICI's share has increased while those of other two institutions declined.

Table 11.2 : Disbursements of Major Financial Institutions

Institution	1998-99		1999-2000		2000-01	
	Amount (Rs. in crore)	% age Share	Amount (Rs. in crore)	% age Share	Amount (Rs. in crore)	% age Share
(A) IDBI	14,470	37.6	17,059	37	17,498	33.9
ICICI	19,225	49.9	25,836	55.9	31,965	62
IFCI	4,819	12.5	3,272	7.1	2,121	4.1
Total	**38,514**	**100**	**46,167**	**100**	**51,584**	**100**

Institution	1998-99 Amount	1999-2000 Amount	2000-01 Amount
(B) All India Financial Institutions	56296	67594	72528
(C) A as % of B	68.4	68.3	71.1

Source : Report on Trends & Progress of Banking in India, 2000-01 (Page 113).

It is evident from the table that the three All-India Financial Institutions account for 71% of the total disbursement of All-India Financial Institutions. Even amongst them the share of ICICI Ltd. is predominant and has consistently increased over the last years.

Table 11.3 : Resources Raised by Major Financial Institutions

	Total		ICICI		IDBI		IFCI	
	1999-2000	2000 2001	1999-2000	2000 2001	1999-2000	2000 2001	1999-2000	2000 2001
Public Issue of Bonds	4648 (28.5)	4062 (21.5)	2575 (37.6)	2901 (27.2)	2074 (27.0)	1161 (21.2)	-	-
Private Placement of Bonds	11663 (71.5)	14806 (78.5)	4274 (62.4)	7777 (72.8)	5603 (73.0)	4320 (78.8)	1787 (100)	2709 (100)
Total	**16311**	**18867**	**6849**	**10678**	**7676**	**5481**	**1787**	**2709**

Source : Report on Trend and Progress of Banking in India, 2000-01 (Page 117).

The above table shows that the financial institutions have largely relied on private placement of their bond of debentures and public issues have contributed to a small percentage. IFCI could not make any public issue of its debentures/bonds because of its unsatisfactory financial position.

The three major financial institutions have prescribed their Prime Lending Rates as follows (as on July, 2001):

Table 11.4 : Structure of Lending Rates of Major Financial Institutions

	IDBI	ICICI	IFCI
Long-Term Prime Lending Rate (for term loans exceeding 3 years)	13.5	12.5	13.0
Medium-Term Prime Lending Rate (loans for 1 year-3 years)	12.5	12.5	–
Short-Term Prime Lending Rate (below 1 year)	12.0	12.5	12.5

Source: Report on Trend and Progress of Banking in India, 2000-01 (Page 117).

11.13 NON-PERFORMING ASSETS

The ratio of net Non-performing Assets (NPA) to net loans as on March 31, 2001 was below 10% in respect of ICICI, SIDBI and Exim Bank. But for IDBI, IFCI and IIBI this ratio was as high as 14.8%, 20.8% and 22.9% respectively. These three institutions are thus, suffering from low quality of their loan portfolios, which affect their profitability and solvancy.

Check Your Progress 3

1) Which changes have been made by Reserve Bank of India over raising of resources by Development Financial Institutions?

....

....

....

2) What do you understand by Exposure Norms? Give details of such norms prescribed for All-India Financial Institutions.

....

....

....

3) Fill in the blanks:

a) Capital Adequacy Norms is expressed as a percentage of ....

b) An Asset of a financial institution becomes non-performing if it remains overdue for ....

c) In the total disbursement of All-India Financial Institution, ... is pre-dominated

11.14 LET US SUM UP

A well-integrated structure of financial institutions has evolved over a period of time. All India Financial Institutions include IDBI, ICICI Ltd., IFCI Ltd., IIBI Ltd., NABARD, NHB, EXIM Bank, TFCI, SIDBI and IDFC. Unlike Commercial banks, development banks (IDBI, IFCI, IIBI, SIDBI, and ICICI) deals with lending funds for medium to long-term for financing the investment in fixed assets of the companies.

Industrial Development Bank of India (IDBI) established in 1964 is the apex banking institutions in the field of long-term industrial finance. It provides both direct and indirect assistance to large and medium-scale enterprises. Industrial

Finance Corporation of India Ltd. established as a statutory corporation under the IFCI Act, 1948 has been converted into public limited company with effect from July 1, 1993. It now has greater flexibility for chalking out its strategies in providing quality services to customers and tapping the capital markets.

ICICI, the first development bank set-up as a joint stock company in India in 1955 has been merged with its subsidiaries namely ICICI Bank Ltd., ICICI Personal Finance Services and ICICI capital. It has become the largest private sector bank in the country having capital adequacy of 11.4%.

Industrial Investment Bank of India (IIBI) originally set up as Industrial Reconstruction Bank of India in 1984, has been converted into a Government company under the Companies Act, 1956 as IIBI. It performs all functions of a development bank, like term loan assistance to medium and large industrial units, equipment financing providing underwriting support to issues of shares and bonds.

Small Industries Development Bank of India is the main institution in the country involved in the promotion, financing and development of industries in the tiny and small-scale sectors.

National Bank for Agricultural and Rural Development (NABARD), established in July, 1982, is a specialised financial institution. It is the Apex financial institution in the area of agriculture finance and rural development. It provides financial assistance to the farm activities and undertakes various development activities. It also regulates the Regional Rural Banks and Co-operative banks.

National Housing Bank (NHB) set up in July, 1988, provides financial and other support to the institutions involved in the housing related activities.

Export-Import Bank of India (EXIM) set up in 1982 facilitates and promotes the foreign trade of India apart from export finance who renders various advisory services to exporters and other entities involved in the foreign trade.

The Development Financial Institutions are basically governed by their own status and charters under which they have been setup. Moreover, these financial institutions are also controlled by the regulations of the Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI). For raising resources, they are required to take permission from the Reserve Bank of India.

In the performance of major financial institutions, ICICI's share has predominated during the recent years and its share has consistently increased over the last three years.

IDBI, IFCI and IIBI have been suffering from low quality of their loan-portfolio.

11.15 KEY WORDS

Bridge Loans : These are short-term loans which are granted to the borrowers of term loans by a bank or financial institutions to enable them to meet their immediate needs for funds. These loans are adjusted/repaid when the term loan is disbursed by the financial institutions.

Equity Assistance Scheme : Assistance, which is provided in the form of subscribing to the equity shares of the company.

Exposure Norms : These norms prescribe the maximum amount of assistance that a financial institution is permitted to provide to a single borrower or a group of borrowers. These norms are expressed as a percentage of the paid-up capital and reserves of the institutions.

Floating Rate Notes : These are debt instruments on which variable interest rate is payable. The rate of interest is linked to a bench-mark rate of interest and changes with the change in such bench mark rate of interest.

Guarantee for Deferred Payments : In case of sale of capital goods, the seller generally grants credit for several years i.e. the cost of the capital goods is recovered in several instalments. For this purpose they require a guarantee by a bank/financial institution.

Pre-shipment Credit : The loans which are provided by Commercial Banks to exporters before the shipment of the goods are called pre-shipment credit. These loans enable the exporters to procure, process and pack the goods for exports.

Promoter's Contribution : The cost of the project is financed from different sources e.g. equity, debt, etc. A part of the cost is required to be provided by the promoters of the project. It is called promoter's contribution.

Project Finance : Project finance is the long/medium-term loan assistance provided by a development bank to the industrial undertakings for setting up, expansion or diversification of an industrial unit.

Refinance of Term Loans : Term loans are provided by Commercial Banks and State Financial Corporation to industrial concerns. On the basis of these loans, these institutions can get loans from Industrial Development Bank of India or Small Industries Development Bank of India. Such loans are called Refinance of Term Loans.

Venture Capital : Venture Capital is that capital which is provided by Venture Capital Fund/ Company to an entrepreneur to undertake a new non-traditional venture with high risk and with the prospects of earning high return. This is provided in the form of equity besides loans.

11.16 SOME USEFUL BOOKS

Annual Report of IFCI, IDBI, SIDBI, NABARD, EXIM Bank, National Housing Bank (latest).

IDBI–Report on Development Banking (1998-99).

Machiraju, H.R. (1998): *Indian Financial System,* Vikas Publication, New Delhi.

RBI–Report on Trend and Progress of Banking in India (2000-01).

Sundaram, K.P.M. and Varshney, P.N. (2000): *Banking and Financial System,* Sultan Chand and Sons, Delhi

Varshney, P.N. and Mittal, D.K. (2002): *Indian Financial System,* Sultan Chand & Sons, Delhi

11.17 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) Commercial banking provides security oriented, short-term lending for meeting working capital requirements, whereas, development banks provide project oriented, medium and long-term funds for financing the fixed assets of the company.

   The development banks are supervised and regulated by the Reserve Bank of India.

2) The main functions of development banks are:

   i) to provide lending funds for medium and long-term for financing the investments in fixed assets, and

   ii) to undertake promotional and development activities and to provide various other types of financial services.

3) The reason for merger of ICICI Ltd. with ICICI Bank Ltd. was to realise their will to emerge as a Universal Bank, so that it can undertake all types of banking and financial business.

Check Your Progress 2

1) Under Equity Assistance Scheme, equity assistance is provided to small industrial units, clients and assistance is released out of National Equity Fund Scheme, Mahila Udyam Nidhi Scheme and Scheme for Employment of Ex-Servicemen.

   Venture Capital Assistance is provided out of venture capital fund to the projects located in high risks, specialised and import substitutive areas.

2) The functions of NABARD are:

   i) providing credit to various form of agricultural activities,

   ii) undertaking various development activities like formulation of credit plans, building of institutions, promotion of research and technologies,

   iii) regulation of regional-rural banks and co-operative banks.

3) The credit facility extended to the overseas banks for enabling them to grant term finance to their clients for import of eligible Indian goods.

4) (i) True (ii) True (iii) False

Check Your Progress 3

1) Development Financial Institutions have been allowed to raise resources from capital market through bonds. Instrument-wise limits have been replaced by overall ceiling for the umbrella limit at 100% of the net owned funds for each financial institution.

2) Exposure norms refer to regulations prescribing credit limits for term lending institutions and refinancing institutions. With effect from March, 2002, the maximum exposure has been reduced to 15% for industrial borrowers, 40% for group borrowers and additional 10% for infrastructure projects.

3) (a) risk weighted assets (b) 3 years (c) ICICI

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UNIT 12 INVESTMENT INSTITUTIONS IN INDIA

Structure

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12.0 OBJECTIVES

The main objectives of this Unit are to enable you to :

- Explain the role of the Insurance Companies as investment institutions in mobilising savings of the people and employing them for developmental purposes,
- Describe the regulations as applicable to these institutions,
- Discuss the mutual funds, their unit schemes and regulations governing them, and
- State the risks associated with investments in mutual funds.

12.1 INTRODUCTION

We have learned that financial institutions facilitate the process of capital accumulation by transferring resources from savers to investors. Investment institutions have occupied important place in the well-integrated structure of financial institution. These institutions are: Life Insurance Corporation of India (LIC), Unit Trust of India (UTI), and General Insurance Corporation of India (GIC).

Though, the insurance companies are primarily engaged in providing the cover of insurance to the people, they mobilise huge sums by way of insurance premia, which they have to invest on a long-term basis. Thus, insurance institutions

emerge as important investment institutions. In India, the Life Insurance Corporation of India has been the single life insurance institution for over four decades. It has built up investment portfolio of significant magnitude. Similarly, in the field of General Insurance, the General Insurance Corporation of India and its four subsidiaries have been actively building up their insurance business and investing their funds. Recently, the insurance sector—both life and non-life (general) – has been opened to the private sector and a single authority— 'Insurance Regulatory and Development Authority' (IRDA) regulates the entire insurance industry.

Mutual Funds have also emerged in India as an intermediary in mobilising people's savings and employing them in money market and capital market securities. Their activities, including investment of funds, are regulated by the Regulations issued by the Securities and Exchange Board of India (SEBI). In this Unit you will study these regulations and the progress achieved by mutual funds. At the end of the Unit, you will become aware about the risks involved while investing in the mutual funds.

12.2 LIFE INSURANCE CORPORATION OF INDIA

In 1956, the life insurance business was nationalised and a single monolithic organisation—the Life Insurance Corporation (LIC) was established under the Life Insurance Corporation of India Act, 1956. It is wholly owned by the Government of India and undertakes the business of life insurance by offering a variety of insurance policies to various segments of the society. In course of undertaking life insurance business, LIC mobilises savings of the masses and employs them in various types of securities and advances. Thus, with a view to safeguard the interests of the policyholders as well as the national interest, the funds at the disposal of LIC are subject to Government regulations. As per the guidelines issued under section 27A of the Insurance Act, 1938, the accretions to the "controlled funds" of LIC were to be invested as follows:

S.No.	Investment Avenue	Quantum of Investment
(a)	Central Government Marketable Securities	Not less than 20%
(b)	Loans to National Housing Bank including (a) above	Not less than 25%
(c)	Central Govt.& State Govt. securities including Govt. guaranteed securities including at (b) above	Not less than 50%
(d)	Socially-oriented sectors including public sector, co-operative sector, and (c) above	Not less than 75%

In respect of the balance 25% of the accretion to the controlled funds, the Government had stipulated that the quantum of investment should be as follows :

S.No.	Investment Avenue	Quantum of Investment
(a)	Loans against policies within surrender values	8%
(b)	Immovable properties	2%
(c)	Investment in Private Sector	10%
(d)	Surplus Cash Balance	5%

In 1997, the above sub-classification of utilisation of funds was removed and LIC was permitted to invest the entire amount under the ceiling of 25% on the basis of commercial judgement but subject to prudential norms.

Table 12.1 : Investment of LIC as on 31st March 2000

(A)	Investments in India	Rs. crore
I	Loans	
	• State Electricity Boards/Power Corporations	7075
	• State Government For Housing	2705
	• National Housing Bank	1002
	• Apex Cooperative Housing Finance Societies	6371
	• Municipalties/Zilla Parishads/ Water Supply Sewage Boards	2000
	• State Road Transport Corporations	375
	• Companies & Co-operative Societies	2830
	• Power Generation	111
	• On Mortgage of Property under Mortgage Schemes of LIC	1152
	• On Insurance Policies	5020
	• Others	285
	Total	**28,926**
II	**Stock Exchange Securities**	
	• Govt. of India Securities	70,533
	• State Government Securities	11,925
	• Other Government Guaranteed Marketable Securities	3,556
	• Power Generation (Private Sector)	1,368
	• Shares	11,482
	• Debentures & Bonds	15,079
	• Others	90
	Total	**1,14,033**
III	Special Deposits with Central Government	2,042
IV	Other Investments	906
	Total (in India)	**1,45,907**
(B)	**Investments out of India**	**458**
	Grand Total	**1,46,365**

It is to be noted from the above table that the major portion of LIC's funds are invested in Stock Exchange Securities, pre-dominantly in Government guaranteed securities. Corporate securities are accountable for a small proportion of total investment. Amongst loans also, bulk of the assistance has gone to financing housing, electricity generation and water supply. Corporate Sector got an insignificant portion. Thus, at the end of March 2000, the sector-wise break up of investment was as follows:

a) Public Sector	84.2 %
b) Co-operative Sector	1.53%
c) Private Sector	14.27%
	100.00%

12.3 GENERAL INSURANCE CORPORATION OF INDIA

General Insurance Corporation of India (GIC) was formed in 1973 after the nationsalisation of a large number of general insurance companies. GIC has 4 subsidiary companies—National Insurance Company Limited, New India Insurance Company Limited, Oriental Fire and General Insurance Company Limited and the United India Insurance Company Limited. Thus, GIC along with its four subsidiaries provide a wide range of policies aimed at meeting the varied needs of the customers in the area of general insurance. These insurance companies earn their income by way of insurance premia and invest the funds in various types of securities and provide loans to the corporate sector. The investment policy of GIC is governed by the Insurance Act, 1938 and the guidelines issued by the Central Government in this regard. In accordance with the regulations enforced from April 1, 1995 the GIC invested the funds in the following types of securities:

S.No.	Investment Avenue	Quantum of Investment
(a)	Central Government Securities	Not less than 20%
(b)	State Govt. Securities & other Government guaranteed securities including (a) above	Not less than 30%
(c)	Housing Loans	Not less than 15%
(d)	Market Sector	Not more than 55%

Thus, GIC was allowed to invest 45% in socially oriented sector, and the balance 55% in the market sector.

12.4 INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY (IRDA)

Government of India has recently opened the Insurance Sector to the private sector. After the enactment of Insurance Regulatory and Development Authority Act, 1999, **IRDA** was set up on April 19, 2000, to –

i) protect the interest of the policy holders, and

ii) regulate, promote and ensure orderly growth of the insurance business.

Reserve Bank of India has issued guidelines to permit the banks and non-bank finance companies business, which have –

i) net worth of not less than Rs. 500 crore in the insurance sector,

ii) Capital Risk Adjusted Assets Ratio (CRAR) not less than 10%,

iii) reasonable level of non-performing assets,

iv) continuously net profit for the last three years, and

v) a satisfactory track record of the performance of the subsidiaries.

Such institutions are permitted to set-up joint venture companies for insurance business with risk participation.

It has granted certificates of registration to 10 life insurance companies and 6 general insurance companies. Twelve companies have already commenced business.

The **IRDA** has issued Investment Regulations for both Life Insurance and General Insurance Companies in 2001. The main points of these guidelines are as follows:

i) **Life Insurance Business**

Funds relating to pension, general annuity business and unit linked life insurance business are to be kept separate from the controlled funds of the insurance company. The controlled funds shall be invested in the following manner :

(a)	Government Securities	25%
(b)	Government Securities or other approved securities including above, not less than	50%
(c)	Approved Investments I Infrastructure and Social Sector, not less than II Others (to be governed by exposure norms) not exceeding	 15% 35%

Infrastructure and Social Sector are defined in the separate Regulations framed by IRDA. Other investment shall be governed by Exposure Norms. Investment in other than approved investments can, in no case, exceed 15% of the fund.

Detailed exposure norms for investments in equity, debentures, terms loans, etc. have been prescribed.

It is to be noted from the above regulations, that while investment in Government and other approved securities continue to constitute 50% of the controlled funds, the remaining 50% will be distributed over :

a) Infrastructure Sector

b) Social Sector including Rural Sector

c) Investment in Securities of all India Financial Institutions

d) Deposits with banks

e) Commercial Paper

f) Treasury Bills

g) Approved Investments under Section 27 A

Thus, in the new regulations, emphasis is laid on insurer's obligation towards rural and social sectors. Investments in the private sector companies, though permitted, will be subject to exposure limits.

ii) **General Insurance Business:** General Insurers will keep invested their total assets in the following manners –

a)	Central Government Securities	: Not less than 20%
b)	State Government securities and other Government guaranteed securities including (a) above	: Not less than 30%
c)	Housing Loans to State Government For housing and fire fighting equipment	: Not less than 5%
d)	Investments in approved investments	
I	Infrastructure and Social Sector	: Not less than 10%
II	Others (to be governed by exposure norms)	: Not less than 55%

Investment in other than approved investments can, in no case, exceed 25% of the assets.

Check Your Progress 1

1) Name the major sectors in which Life Insurance Corporation's funds are invested.

....

....

....

2) State the objectives behind setting up IRDA.

....

....

....

3) State whether following statements are true or false:

   1) Out of the total controlled funds of the insurance companies, 30% are required to be invested in Government securities. (T/F)

   2) As per IRDA regulations, investment in the private sector companies is subject to exposer norms. (T/F)

12.5 MUTUAL FUNDS

A Mutual Fund is an investment vehicle, which collects the savings from the surplus units by floating various unit schemes, and invests the amount so collected in the securities of industrial enterprises. Thus, a Mutual Fund collects the savings of investors who are not able to directly invest their savings into industrial securities and then invests the aggregate funds into securities, which have been thoroughly researched. Mutual Funds therefore, provide the advantage of professional management for the savings of the small investors besides diversification of risks as the funds collected are invested into large number of securities and other instruments.

12.5.1 Schemes of Mutual Funds

Mutual Funds are permitted to float different Unit Schemes with different objectives. For example, one of the objectives of the schemes may be to provide regular income or utmost liquidity or capital appreciation, etc. Mutual Funds in India have introduced a large number of Unit Schemes. At the end of March, 2001, there were 65 Unit Schemes floated by public sector mutual funds (excluding UTI), while 158 schemes were floated by private sector mutual funds. These schemes are broadly classified into two categories as follows :

1) **Closed-end Schemes** : The schemes which are open for

public subscription for a definite period, say 2 or 3 months, are called closed-end schemes. Whatever funds are collected by the schemes during that period constitute the corpus of the scheme, which remains the same. Such, schemes have definite maturity period, say 5 or 7 years, after which they stand terminated. Mutual Funds redeem the units at the prevailing NAV by liquidating the securities in which they had invested the funds of the scheme. The units of the closed-end schemes are transacted at the stock exchanges.

2) **Open-end Schemes** : Open-end Schemes are those, the subscription for which from the investors is solicited on a continuing basis. The investors can join the schemes at any time they like. The corpus of the scheme varies over time due to ongoing purchases and redemptions. There is no time for maturity of the scheme.

In case of open-end schemes, the Mutual Fund provides liquidity to the investors by re-purchasing the units at a price linked with NAV. Sometimes, the closed-end schemes are either extended or rolled over i.e. continued for another period, some of them have been later on converted into open-end schemes.

The open-end schemes can be wound up if the total number of units outstanding (after repurchases) fall below 50% of the original number of investors.

Types of Schemes

Some important types of Unit-Schemes floated in India are as follows:

1) **Income Fund** : Its objective is to earn optimum returns and maintain a balance of safety, yield and liquidity. The investments are made largely in fixed income securities.

2) **Growth Fund** : Its objective is to generate long-term capital appreciation from a portfolio which is invested in equity and equity related instruments.

3) **Balanced Fund** : Its objective is to generate capital appreciation along with current income. The investments are made in combined portfolio of equity and equity related instruments and debt and money market instruments.

4) **Liquid Fund** : It provides income consistent with a high-level of liquidity. Portfolio comprises of money market and debt instruments.

5) **Gilt Fund** : Its objective is to generate credit risk-free returns by investing in Central Government and/or State Government securities.

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6) **Tax Saving Plan** : It provides tax relief to the investors. Its objective is to generate long-term capital appreciation. It invests in equity and equity related instruments. There is a lock-in period for the units under this plan i.e. the units cannot be sold till the completion of the lock-in period, say 2 or 3 years.

7) **Index Fund** : This is also a growth fund but it is linked to a specific index of share prices. It means that the funds are invested principally in the securities of companies whose securities are included in the index concerned. Thus, the funds performance is linked to the growth in the concerned index. e.g. NIFTY.

8) **Sector Fund** : It is also a variant of Growth Fund. Under it, funds are invested in equity or equity related instruments of a selected sector, e.g. technology, pharmaceuticals, etc.

12.5.2 Unit Trust of India

Unit Trust of India (UTI) was the first Mutual Fund set up in India way back in 1964, under the Unit Trust of India Act, 1963. It has been given a special status as it has been set up under a separate Law of Parliament and not as a company.

Its initial capital Rs. 5 crore was contributed by IDBI, LIC, SBI and its subsidiaries and other Scheduled banks. UTI is managed and controlled by a Board of Trustees. Its Chairman is appointed by the Government of India, while four trustees and the Executive Trustee are appointed by IDBI. Other contributors to the initial capital appoint the remaining trustees.

Unit Scheme, 1964 is the oldest and biggest Unit Scheme of the UTI. It is an open-end scheme. Its provisions are incorporated in the UTI Act itself. Besides this scheme, the UTI has introduced a large number of Unit Schemes– both open end and closed end– to mobilise the savings of different classes of investors. These schemes have different investment objectives. As on June 30th, 1998, 79 Unit Schemes were in operation consisting of 28 open-end schemes and 51 closed end schemes. Thus, Unit Trust of India has mobilised the largest amount from unit holders among the Mutual Funds and is the biggest Mutual Fund in India.

Unit Scheme, 1964

The UTI sells units under this scheme throughout the year except in the month of June at a price determined by it. It also repurchases these Units from the unit holders at a re-purchase price, also determined by it. In July, every year UTI announces conscessional sale and repurchase prices, which are increased continuously during the subsequent

months. The UTI Act lays down the formula for determining these prices, which have not been exactly Net Asset Value (NAV) based till recently. Thus, UTI has been authorised to fix these prices deviating from the basic principle of NAV based pricing.

Since its inception, the UTI commanded utmost public confidence. It gradually raised the rate of dividend on US 64 from 6.10% in 1964-65 to 26% in 1991-92 to 1994-95.

Crisis in US 64

Towards the end of September 1998, **US 64** faced a serious crisis, when it was reported that **US 64's** balance sheet carried negative reserves of Rs. 1098 crores as on June 30th 1998. Thus, it was realised that the net asset value of the Units was below par, while it was selling new units at Rs. 14 per unit. This led to heavy risk for redemption of units by the unit holders and at the same time also resulted in panic selling of equity shares, as large-scale off-loading of shares by UTI was expected. Sensex declined by 220 points in a few days. UTI, however, faced the situation with the financial assistance from the Reserve Bank of India.

Causes of Crisis

A Committee under the Chairmanship of Shri Deepak Parekh investigated the causes of the crisis, which are summarised below:

i) The proportion of equity in the investment portfolio of US 64 increased considerably from 21% in 1986 to 63% in 1998. The share of interest income in the total income of UTI, therefore, fell considerably. Hence, UTI had to sell good quality shares to book profits in order to meet dividend obligation. Consequently, the quality of the residual equity with the UTI deteriorated considerably. Moreover, it invested in many low quality equity issues.

ii) As already noted, the sale and repurchase prices were set by UTI without any regard to the Net Asset Values of underlying securities. Thus, whenever the share prices fluctuated, the unit prices remained unaffected, primarily to retain investor's confidence.

iii) UTI followed the policy of distributing dividends at gradually increasing rates since inception. During 1995-97, UTI preferred to draw on reserves to maintain dividends rather than to reduce the dividend rate.

By implementing the major recommendations of the Deepak Parekh Committee Report, the UTI felt some improvement in its financial position and it declared a dividend of 13.5% in 1998-99, which was mainly through booking profits by selling

equities. NAV of the **US 64** also improved. But in July 2001, US 64 suffered another major crisis. The Unit Trust of India, slashed the rate of dividend to 10% from 13.5% in the previous year and suspended the sale and repurchase of units for six months till December 2001. Trading in US 64 units was allowed at the National Stock Exchange only.

The deterioration in the financial health of **US 64** scheme was due to several factors, namely–

i) Equity market suffered set back from the beginning of 2001, share prices went down by 25%.

ii) UTI faced heavy redemption of Units in April and May, 2001 at the prevailing repurchase price, while the NAV was much lower.

iii) With the decline in share price, capital gains could not be attained, to the desirable extent, to distribute dividend.

iv) Reserves of **US 64** consequently turned negative.

A bailout package for small investors was announced in July, 2001. Unit holders with holding of upto 3000 units were allowed the repurchase facility at Rs. 10/- per unit from August 1st, 2001. This repurchase price was increased by 10 paise per unit every month till it reaches Rs. 12/- in May 2003. Later on, this special repurchase facility was permitted for holders of upto 5000 units.

From January 2002, **US 64** has been made NAV linked scheme. Investors upto 5000 units are permitted to sell either at the above-mentioned assured repurchase price or at NAV linked price, whichever is higher. But units above 5000 are to be sold at NAV linked price from January 2002.

NAV of **US 64** has remained below par. These units were transacted at National Stock Exchange at Rs. 8.25 per unit on July 24, 2001. This price increased to Rs. 9.30 per unit on August 8th, 2001. The NAV has fallen considerably to approximately Rs. 6.50 recently.

The present financial position of UTI is far from being satisfactory. For the first time in its 38 year old history, it has declared no dividend for the year 2001-02. The Government has been providing budgetary support to unit holders to the extend of the gap between NAV and the assured repurchase price as announced on July 15, 2001. If dividend was declared, it would have increased the gap between the NAV and the special repurchase price and consequently the budgetary commitment of the Government.

UTI is also experiencing short-fall in the monthly income plans maturity in June and August 2002. It has tied up

with State Bank of India for a line of credit of Rs. 1000 crore, with a guarantee from the Central Government. The short-fall would be met through the UTI's Development Reserve Fund.

The UTI is thus, surviving on Government support and bank borrowings. The pioneering investment institution is in such a deplorable state of affairs. How far will it fulfil its commitments and obligation, only the future will reveal.

At present the UTI has over 58 NAV-linked schemes. Apart from **US 64** scheme, all other schemes are SEBI compliant through a voluntary agreement. Even **US 64** has become SEBI compliant to the extent that it has been NAV linked since January 1st, 2002. The Government intends to restructure UTI by repealing the Act and bringing the UTI directly under the purview of SEBI Act.

12.5.3 Other Mutual Funds

UTI enjoyed the monopoly position until 1987 when mutual funds were allowed to be set-up in the public sector. Leading public sector banks – State Bank of India and Canara Bank set up their mutual funds, followed by other nationalised banks such as Punjab National Bank, Bank of India and Indian Bank, Life Insurance Corporation and General Insurance Corporation also set up their Mutual Funds. In 1993, Mutual Funds were permitted to be set up in the private sector also. This liberalisation induced a large number of private companies including foreign mutual funds to float mutual funds in India.

12.5.4 Governance of Mutual Funds

Mutual Funds are governed by SEBI (Mutual Fund) Regulation Act, 1996. The Securities and Exchange Board of India has issued guidelines for the all-round development and regulation of Mutual Fund Industry.

The salient features of these regulations are as follows :

1) **Registration of the Mutual Fund** : A Mutual Fund can be set up only after a Certificate of Registration has been obtained form SEBI on an application made by its sponsor.

2) **Sponsor** : Sponsor is an entity that establishes mutual fund. The sponsor is required to have a sound track record and general reputation of fairness and integrity. The sponsor should be carrying on business in financial services for a period of not less than five years, its net worth is positive in all the immediately preceding five years and has earned profits in three out of the immediately preceding five years including the 5th year.

3) **Trustees** : A Mutual Fund shall be constituted as a Trust and the Trust Deed should be registered under the Indian Registration Act, 1908. A person eligible for appointment as a trustee should be a person of ability, integrity and standing. At least 50% (now 2/3rd) of the trustees should be independent trustees not associated with sponsors. The role of trustees is to supervise and monitor the activities of the Assets Management Company. The trustees and the Asset Management Company should enter into Investment Management Agreement.

4) **Asset Management Company** : An Asset Management Company (AMC) should be appointed by the Sponsor or the Trust, if so authorised by the Trust Deed. The Board of Directors of the Asset Management Company should have at least 50% of the Directors who are independent of the Sponsors or the Trust. The Asset Management Company cannot undertake any other business activity except in the nature of management and advisory services.

5) **Custodian** : The Mutual Fund should appoint a custodian to carry out the custodial services for the schemes of the fund.

6) **Offer Period** : Any scheme of a Mutual Fund should remain open for subscription for a maximum period of 45 days. The AMC should specify the minimum subscription amount, it seeks to raise under the schemes and the extent of over-subscription it intends to retain, in case of over-subscription.

7) **Pricing of Units** : The Mutual Fund should calculate the net asset value of each scheme and publish the sale and repurchase price of the units at least once a week, in case of open ended funds. The Mutual Funds also ensure that the repurchase price is not lower than 93% of the Net Asset Value and the sale price is not more than 107% of the Net Asset Value. In case of close-ended schemes, the repurchase price should not be less than 95% of the Net Asset Value.

8) A copy of the offer document for any scheme of the Mutual Fund has to be filed with SEBI, which can suggest modifications in the schemes in the interest of investors.

9) The advertisement in respect of each scheme shall be in conformity with the advertisement code prescribed by SEBI.

10) Mutual Funds are required to invest their funds in transferable securities in the money market, or in the capital market or in privately placed debentures or securitised debts. Investments should be made subject to the investment restrictions specified in the Regulations.

11) Mutual Funds are permitted to borrow to meet temporary

liquidity needs for the purpose of re-purchase, redemption of units or payment of interest or dividend to the unit-holders. Such borrowings shall not exceed 20% of the net assets of the scheme and the duration of borrowing shall not exceed 6 months.

12) SEBI has specified the valuation norms according to which every Mutual Fund shall carry out valuation of its investments and publish the same.

13) SEBI is authorised to undertake inspection of the books of accounts, records, infrastructure, systems, etc. and to investigate the affairs of a Mutual Fund, the trustees and Asset Management Company. SEBI may appoint an auditor also for these purposes.

14) SEBI is authorised to suspend a certificate granted to a Mutual Fund if it contravenes any of the provisions of the SEBI Act and the Regulations or otherwise fails/defaults in meeting its obligations.

15) SEBI can also cancel the Certificate of Registration granted to a Mutual Fund, if the Mutual Fund –

    a) is guilty of fraud, or has been convicted of an economic offence,

    b) has been guilty of repeated defaults,

    c) the Mutual Fund, Asset Management Company (AMC), Trustee of the Mutual Fund indulges in price manipulation or price rigging or cornering activities affecting the securities market and the investor interest,

    d) financial position of the Mutual Fund deteriorates so that its continuance is not in the interest of unit holders and other mutual funds.

16) SEBI is also empowered to take action for suspension or cancellation of registration of an intermediary holding a Certificate of Registration, who fails to exercise due diligence or comply with the obligations under the Regulations.

12.5.5 Investment Restrictions

Mutual Funds invest the funds mobilised from the investors in Capital Market and Money Market securities. The selection of the securities depends upon the investment objectives of respective Unit Schemes. For example, the growth schemes largely aim at capital appreciation, along with reasonable income. Thus, funds under such schemes are largely invested in equities.

Securities and Exchange Board of India (SEBI) has prescribed the following investment restrictions for Mutual Fund:

1) All the investments of the Mutual Funds will be in transferable securities (whether in the Capital Market or Money Market) or bank deposits or in money call or in privately placed debentures and securitized debt.

2) No loans for any purpose can be granted.

3) Under all its schemes, a Mutual Fund will not own more than 10% of any company's paid up capital carrying voting rights.

4) Each scheme shall not invest more than 15% of its Net Asset Value (NAV) in debt instruments issued by a single issuer, which are rated not below investment grade by a credit rating agency. Such investment may be extended to 20% of the NAV of the scheme with the prior approval of the Trustees and the Board of the AMC. Such limit will not apply to investments in Government securities and money market instruments.

5) Investments within the above limit can be made in mortgage backed securtised debts, which are rated not below investment grade by a credit rating agency.

6) Each scheme shall not invest more than 10% of its NAV in unrated debt instruments issued by a single issuer. Total investment in such instruments shall not exceed 25% of the NAV of the scheme.

7) Till the funds are deployed as per the investment objective of the scheme, moneys under the scheme may be invested in short-term deposits of scheduled commercial banks.

8) No scheme of the Mutual Fund shall make any investment in :

   a) any unlisted security of an associate or group company of the sponsor, or

   b) any security issued by way of private placement by an associate or group company of the sponsor, or

   c) the listed securities of group companies of the sponsor which is in excess of 25% of the net assets.

9) No scheme of the Mutual Fund shall invest more than 10% of its NAV in the equity shares or equity related instruments of any company.

10) Each scheme shall not invest more than 5% of its NAV in the unlisted equity shares or equity related instruments.

11) Transfer of investments from one scheme to another scheme in the same Mutual Fund shall be allowed if –

   a) Such transfers are made at the prevailing market price

for quoted securities on short basis.

b) The securities so transferred shall be in conformity with the investment objective of the schemes to which such transfer has been made.

12) The fund may buy or sell securities on the basis of deliveries and shall not make any short sales or engage in carry forward transaction or badla finance. Derivatives transaction in a recognised stock exchange is permitted for the purpose of hedging and portfolio balancing.

Check Your Progress 2

1) Distinguish between–

a) Closed-end Schemes and Open-end Schemes

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b) Index Fund and Sector Fund

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2) Explain the following:

a) Asset Management Company

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b) Sponsor

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3) Fill in the blanks:

a) The Mutual Funds are allowed to invest not more than .... of its NAV in equity shares or equity related instruments of a company.

b) Each scheme shall invest not more than .... of its Net Asset Value in unrated debt instruments of a single issuer.

c) Transfer of securities from one scheme to another is permitted at .... for quoted securities.

12.5.6 Performance of Mutual Funds in India

Till 1993, there were 7 Mutual Funds, all in the public sector, which had launched 116 schemes mobilising Rs. 8,011 crores from the market. Since then the number of Mutual Funds operating in India has grown up to 27, with Mutual Funds being allowed to be set up by private sector companies including foreign companies. The total number of schemes floated by these funds increased to 196 and the funds mobilised to Rs. 13,890 crores till 1995-96.

The cumulative resources mobilised by Mutual Funds in India till 1995-96 are shown in the following table:

Table 12.3 : Sector-wise Funds Raised by Mutual Funds (1986-87 to 1995-96)

Year (upto)	Public Sector	Private Sector	Sub Total	UTI	Total
1986-87	-	-	-	4563.68	4563.68
1987-88	-	-	-	6738.81	6738.81
1988-89	1621.00	-	1621.00	11834.65	13455.65
1989-90	1460.00	-	1460.00	17650.92	19110.92
1990-91	1683.97	-	1683.00	21376.48	23060.45
1991-92	5674.51	-	5674.51	31805.69	37480.20
1992-93	8011.21	-	8011.21	38976.81	46988.02
1993-94	8407.21	916.00	9323.21	51978.00	61301.21
1994-95	10550.21	3000.00	13550.21	61500.00	75050.21
1995-96	10667.00	3223.00	13890.00	66700.00	80590.00

Source : Mutual Funds Report, Securities & Exchange Board of India, 1996

Table 12.4 : Resources Mobilised by Mutual Funds 1997-98 to 2000-01 (Rs. in Crore)

Mutual Funds	1997-98	1998-99	1999-2000	2000-01
I Bank sponsored	236.89	-88.34	155.58	348.23
• SBI MF	190.11	-71.79	477.60	351.88
• Canara Bank MF	46.78	-16.55	-361.63	-5.41
• Indian Bank MF	-	-	-	-
• Bank of India MF	-	-	-	-
• PNB MF	-	-	40.72	2.12
• Bank of Baroda MF	-	-	1.71	0.36

.....continued

continued........				
II FI-s Sponsored	203.39	546.81	357.41	1274.51
• GIC MF	-19.20	-12.05	-206.28	-41.81
• LIC MF	99.75	348.36	284.52	566.00
• IDBI MF	122.84	210.50	279.17	750.32
• Unit Trust of India	2875.00	2060.90	4548.00	1990.00
III Private Sector MFs	748.62	2060.90	14892.17	9717.35
Total	**4063.90**	**2695.37**	**19953.16**	**13339.09**

Source : Report on Trends & Progress of Banking in India 2000-01.

12.5.7 Risk Factors

Investment in the Units of the Mutual Funds is not without inherent risks. Mutual Funds invest in transferable securities at current market prices, which may vary over a period of time. This results in the variation in the Net Asset Value (NAV) of the units. NAV of the Units of the schemes is computed as follows :

NAV (Rs.) : Market or fair value of securities investments + current assets — current liabilities and provisions

= No. of outstanding units under the scheme

The Fund values its investments according to the valuation norms, as specified in SEBI regulations.

NAV is calculated at the close of every business day. NAV is significant to the investors because redemption (or repurchase) of the units by the Fund depends upon the NAV. Sometimes, an exit load is also charged on redemptions. Exit Load means that a small amount, ½ say or 1 per cent is deducted from the NAV while making repayment to the investors.

Following risks are involved in investing in Mutual Funds :

1) Mutual Funds and securities investments are subject to market risks. There is no assurance or guarantee that the scheme's objectives (e.g. capital appreciation or regular return) will be achieved.

2) The Net Asset Value of units may go up or go down depending on various factors and forces affecting the capital markets. Thus, the redemption value of the units will also change accordingly.

3) Past performance of the Mutual Fund does not indicate future performance.

4) The sponsor is not responsible or liable for any loss or shortfall resulting from the operations of the scheme, except up to the initial contribution towards the setting up of the Mutual Fund.

5) Investors in the schemes are not being offered any guarantee or assured return.

Check Your Progress 3

1) List any three risks involved in investing the Mutual Funds.

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2) What has been the performance of private sector Mutual Funds in raising resources during recent years?

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12.6 LET US SUM UP

Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC) and Mutual Funds are premier investment institutions. Although the main task of insurance companies is to provide insurance cover to the people, yet they mobilise huge sums of insurance premia, which is invested on long-term basis.

LIC established in 1956, under the Life Insurance Corporation of India Act, 1956, is wholly owned by the Government of India and undertakes the business of life insurance by offering a variety of insurance policies to various segments of the society. It mobilises savings of the masses and invests its funds in various types of securities and advances under the guidelines issued under Section 27 A of the Insurance Act, 1938.

GIC set up in 1973 has four subsidiary companies namely, National Insurance Company Ltd., New India Assurance Company Ltd., Oriental Fire and General Insurance Company Ltd. and United Insurance Company Ltd. These companies invest their income earned through insurance premia into various types of securities and provide loan to the corporate

sector. Its investment policy is governed by the Insurance Act, 1938.

With a view to protect the interests of the policy holders and to ensure the orderly growth of insurance business, Insurance Regulatory and Development Authority has set up under Insurance Regulatory and Development Authority Act, 1999. This statutory body issues the investment regulations for both life insurance and general insurance companies.

Mutual Funds as an investment vehicle collect the savings from surplus units by means of floating unit schemes and invest the amount in the securities of industrial enterprises.

Unit Trust of India, the first Mutual Fund was set up in 1964, under Unit Trust of India Act, 1963. Presently it has 58 NAV linked schemes in operation. All these schemes including **US 64** are under compliance of SEBI. After 1987, leading public sector banks like State Bank of India, Canara Bank, PNB, LIC, GIC have set up their Mutual Funds. Since, 1993, even the private sector has also been allowed to set up their Mutual Funds. Mutual Funds are governed by SEBI regulations. Broadly two types of schemes are floated by the mutual funds: closed-end schemes and open-end schemes.

The number of Mutual Funds have increased from 7 till 1993 to 27 in 1995-96. The number of schemes floated by these funds increased to 196, mobilising the funds to the extent of Rs. 13,890 crores. Various risks are involved in investing in Mutual Funds. Important among these are: no assurance or guarantee over fulfilment of objectives of the schemes, uncertainty in the net value of units, no linkage of past performance of mutual fund with its future performance, etc.

12.7 KEY WORDS

Controlled Fund : Controlled fund means all funds pertaining to life insurance business of an insurer.

Government Guaranteed Securities : Those securities which carry the guarantee of the Government regarding payment of interest and repayment of principal.

Growth Fund : It is the fund/schemes of the Mutual Fund, which invests in equities, and

equity related instruments. Its objective is to generate capital appreciation.

Hedging : It is a method whereby one can protect himself against the loss likely to be incurred in a transaction. He undertakes another transaction for this purpose.

Index Fund : It is a growth fund. It is linked to a special index of share price. It invests in the securities of companies, which are included in the index concerned.

Market Sector : It implies investment of insurance funds in securities which are available in the capital market, besides Government and Government guaranteed securities.

Net Asset Value : It is equal to the net assets of a Unit Scheme divided by the number of outstanding units under the schemes. Net assets is the sum total of the market value of all investments plus accrued income minus the liabilities and expenses for the scheme concerned.

Sector Fund : It is also a growth fund. It invests in equity or equity related instruments of a selected sector of the economy, e.g. technology.

Social Sector : Those sectors of the economy which involve the society at large are called social sector, e.g. water supply, drainage, housing rural sector etc.

12.8 SOME USEFUL BOOKS

Bhole, L.M. (2000): *Financial Institutions and Markets,* Tata Mc Graw Hills, New Delhi

Machiraju, H.R. (1998): *Indian Financial System,* Vikas Publishing House, Delhi

Reserve Bank of India–Report on Trend and Progress of Banking in India (2000-01).

Varshney, P.N. and Mittal, D.K. (2002): *Indian Financial System,* Sultan Chand and Sons, New Delhi.

12.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) The major sectors in which Life Insurance Corporation's funds are invested are:

   i) Central Government marketable securities,

   ii) Loans of National Housing Bank,

   iii) Central Government and State Government securities, and

   iv) Socially oriented sectors.

2) The objectives for setting up IRDA are: (a) to protect the interests of the insurance policy holders, and (b) to regulate the insurance business so as to ensure its orderly growth.

3) (i) False (ii) True

Check Your Progress 2

1) a) Close-end schemes remain open for public subscription for a definite period, whereas open-end schemes remain open on continuing basis.

   b) Under Index Fund, the funds are invested in the securities of companies whose securities are included in the index concerned. Under Sector Fund, funds are invested in the equities of a selected sector.

2) i) **Asset Management Company** refers to a company which does not deal in any business activity except in the nature of management and advisory services.

   ii) The sponsor is an individual or institution that establishes a Mutual Fund.

3) i) 10% (ii) 10% (iii) At the prevailing market price

Check Your Progress 3

1) i) Securities investments are subject to market risks,

   ii) The Net Asset Value of units may go up or down, and

   iii) No guarantee or assured returns on the schemes.

2) The performance of private sector Mutual Funds has been quite impressive till 1999-2000. However, its performance has gone down in 2000-2001.

UNIT 14 INDIA AND THE GLOBAL FINANCIAL SYSTEM

Structure

14.0 Objectives
14.1 Introduction
14.2 International Financial Institutions
 14.2.1 International Monetary Fund (IMF)
 14.2.2 International Bank on Reconstruction and Development (IBRD)
 14.2.3 International Finance Corporation (IFC)
 14.2.4 International Development Association (IDA)
 14.2.5 Asian Development Bank (ADB)
14.3 European Monetary System
14.4 Euromarket
14.5 India and Foreign Currency Finance
 14.5.1 External Commercial Borrowings
 14.5.2 Euro Issues-GDRs
 14.5.3 Foreign Direct Investments
 14.5.4 Portfolio Investments
 14.5.5 Non-Resident Indians' Deposits
14.6 Let Us Sum Up
14.7 Key Words
14.8 Some Useful Books
14.9 Answers/Hints to Check Your Progress

14.0 OBJECTIVES

After going through this Unit, you will be able to:

- Summarise the functioning of International Financial Institutions like IMF, IBRD, IFC and IDA etc, in terms of their objectives, organisational structure, functions and financing schemes being run,
- Explain the Euro Market and its segments,
- State the sources of raising long/medium-term foreign currency finance for Indian companies, and
- Describe the European Monetary System.

14.1 INTRODUCTION

In this age of globalisation, no country could remain in isolation. So, is the case with the financial system of a country. In developing countries like India, there is a greater need for foreign investment depending on foreign sources of finance. We have different sources to obtain the same. There are international financial institutions, which lend for specific purposes in deserving cases. Besides, there are various other avenues of taping foreign currency resources by Indian corporates both in the form of equity and debt obligations.

During recent years there had been growing inflow of funds through these channels into India. In this Unit, we shall study about these sources of external finance available to India.

14.2 INTERNATIONAL FINANCIAL INSTITUTIONS

14.2.1 International Monetary Fund

The International Monetary Fund (IMF) came into existence at the Bretton Woods conference held in July 1944 with 44 countries as its members. Currently, most of the countries, with the exception of Cuba, are its members. IMF is the central institution of the international monetary system. The major objective of IMF is to help its member countries in correcting the balance of payment imbalances. This improvement is brought about through changes in macro-economic policies. Keeping this in view, IMF conducts studies and recommends changes in the areas of monetary, tariff and exchange rate policies. IMF, in recent times, has taken active role in longer-term efforts to solve the third-world debt problem.

Objectives : The objectives of the IMF, as set out in its Articles of Agreement, are as follows :

i) To promote international monetary co-operation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

ii) To facilitate the expansion and balanced growth of international trade and thereby to contribute the promotion and maintenance of high levels of employment and real incomes and to the development of the productive resources of all members as primary objectives of economic policy.

iii) To promote exchange stability so as to maintain orderly exchange arrangements among members, and avoid competitive exchange depreciation.

iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

v) To generate confidence among its members by making the general resources of the Fund temporarily available to them. This provides them the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive to national or international prosperity.

vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the balance of payments of its member countries .

Thus, in addition to monitor the proper conduct of the international monetary system, IMF also provides assistance to countries facing temporary balance of payments crisis.

Organisational Structure : The IMF is an autonomous organization with 181 countries as its members. The highest policy-making body is the Board of Governors in which each member-country is represented by a Governor and an alternate Governor. The administrative responsibilities are vested in the Board of Executive Directors.

Exchange Rates : As stated above one of the objectives of IMF is to promote exchange stability. To achieve this, initially each member country was required to establish the par value of its currency in terms of gold or US dollars and to undertake to maintain the same within 1% of the declared par value. The par value was permitted to be changed with the prior approval of the IMF. Such a change was permitted if the member country was suffering from a fundamental disequilibrium in its balance of payments. The system came to be known as 'adjustable peg system' as it provided for the adjustment of exchange rates.

The above arrangement continued till early seventies of the previous century. After a series of devaluation of the US dollars, the system called the Bretton Woods System, finally collapsed in Mach 1973, when 14 major nations decided to float their currencies. Currently, about 1/3rd of the IMF member countries have floated their currencies—some have fixed parity of their currency with US dollars, some have fixed with French Francs, while others have fixed with SDRs.

Resources : The main resource of the IMF is the subscription made by the member-countries to its capital. Contribution by each member country is called the Quota, which is based on various factors such as country's national income, reserves, exports variability and ratio of exports to national income. Initially, member countries were required to subscribe to the quota in the form of gold or US dollars to the extent of 25% and the balance, in the form of country's own currency. Presently, however, the contribution in gold may be made in the form of Special Drawing Rights (SDRs) or other foreign currencies. Quotas are reviewed at intervals of not more than five years. In 1994, the capital of the IMF was SDR 144.6 billion.

Besides the subscriptions against the quotas received from the member countries, the IMF also has the power to borrow under the "General Arrangement to Borrow". Under this arrangement, the ten industrialised countries agreed to lend

to the IMF their own currencies up to a limit agreed upon. Originally, IMF could borrow these funds, under this arrangement, only when the participant countries need the funds. However, now the IMF can also have access to these funds to finance drawings by other countries, provided the borrowing countries agree to economic adjustment programme approved by the IMF.

Special Drawing Rights (SDRs)

The monetary system propounded at the BrettonWoods played a positive role in the rapid expansion of the world trade. However, one of its major shortcomings was that there was no provision for expanding the supply of international reserves necessary to support expanding trade. This eventually led to increase in holdings of national currencies, and in particular it strengthened the position of US dollars as the international reserve currency. The US dollars became the reserve asset of the new monetary system. But with the world trade growing, the need for international liquidity grew. To meet this need for international currency, continuing deficit in US balance of payment, it was essential to put dollars into the system. This shortage of international liquidity reached its height in late 1960s. The IMF countered this problem by the creation of a new international reserve asset called the **'Special Drawing Rights (SDRs)'**, in 1969.

Originally, the SDR was equivalent to a fixed number of dollars. Now, it is a basket of various currencies such as US dollars, German Deutschmarks, Japanese Yen, French Francs and British Pound Sterling. These SDRs were allocated to the member countries in 1969 just as bonus shares are issued to the shareholders of a company.

Financing Schemes : One of the objectives of the IMF is to provide financial support to member countries, which are facing balance of payment deficits. The most important window of financing is the Drawing from the IMF. Under this scheme, whenever a member country requires foreign currency to tide over its short-term deficits in the balance of payments position, it tenders its own currency to the IMF and gets the required foreign exchange. This is called as "drawings" from the IMF. Once the balance of payments position of the borrower country improves, it "repurchases" its currency and pays back the foreign currency. Ordinarily, a member can draw not more than 25% of its quota during 12 months period. The aggregate drawing by a member can go up to a level where the IMF's holding of the concerned member country's currency reaches 200% of the quota. For example, if country "A" has a quota of SDR 100, of which 75% has to be contributed in its own currency i.e. country A contributed equivalent of SDR 75 in its own currency. Country A can borrow up to a maximum of SDR 125 so that the total holding of the country A's currency would reach

SDR 200 which is 200% of the country's quota. This condition can, however, be waived in special circumstances.

The process of a member country to draw from the IMF is divided into stages or "Tranches". The borrowing which takes the IMF's holding of the borrowers' own currency to 100% of the country's quota is called the "Reserve Tranche". Any borrowing beyond the reserve tranche is divided into four equal tranches called the "Credit Tranches". A country can freely draw upon the reserve tranche but drawings from the credit tranches are subject to scrutiny by the IMF.

The IMF also has other schemes of financial assistance. Some of the schemes are as follows :

i) **Standby Arrangements** : Under this arrangement, a member is allowed to draw upon the resources of the IMF up to a specific limit and within a specific time frame. Such facility is to be negotiated between the IMF and the member country. It is similar to the overdraft facility offered by commercial bank.

ii) **Structural Adjustment Facility** : This scheme is aimed at providing financial assistance to member countries facing prolonged balance of payment problems and as remedial measures follow the medium term macro economic structural adjustment programme (SAP). SAP in such countries aims at fostering growth and strength-ening the balance of payments position. Loans privided under SAP are in proportion to the member country's quota. These loans are normally disbursed over a period of three years during which the borrower country has to draw up three-year comprehensive strategy for ensuring structural adjustment.

iii) **Enhanced Structural Adjustment Facility** : This scheme is similar to the Structural Adjustment Facility but is meant specifically for the poorest member-countries when they are undertaking a strong three year macro-economic and structural programme.

iv) **Extended Fund Facility** : The Extended Fund Facility has been formulated to assist the member countries in meeting their balance of payment deficits for longer periods and in larger amounts than available under the normal drawings programme. This facility is for countries suffering from serious balance of payments problems due to structural maladjustment in production, trade and prices.

14.2.2 International Bank for Reconstruction and Development (IBRD)

International Bank for Reconstruction and Development (IBRD) more popularly known, as World Bank, is also the

creation of the Brettonwoods Conference held in 1944. The main function of the World Bank is to provide long-tem financial assistance to its member countries for their reconstruction and development. Initially, the World Bank concentrated its efforts on the war-ravaged economies of Europe but later shifted its focus to the development of backward countries.

Functions : The main functions of the World Bank are:

i) To assist in reconstruction and development of its member-countries by facilitating investment of capital for productive purposes.

ii) To promote foreign private investment by guaranteeing of or through participation in loans and other investments of capital for productive purposes.

iii) To make loans for productive purposes out of its own resources or out of the funds borrowed by it where private capital is not available on reasonable terms.

iv) To promote the long-term growth of international trade and the maintenance of equilibrium in the balance of payments of members by encouraging international investment for the development of the productive resources of members.

Thus, the World Bank provides funds for productive projects, which lead to economic development in its member countries.

Organisational Structure : The management of the World Bank consists of a Board of Governors, Executive Directors and a President. Of the 22 Executive Directors, 5 are nominated by the 5 biggest shareholders–USA, UK, Germany, Japan and France. The President acts as the Chairman of the Board of Executive Directors. The voting rights of the Governors and the Executive Directors are proportionate to the share-capital of the member country they represent. Hence, the policies of the World Bank tend to be influenced by the large shareholder countries.

Resources : The resources of the World Bank consist of the capital contributions from its member countries besides the borrowings from the international capital markets. Initially, the capital of the World Bank was $ 10,000 million, which was contributed in Gold or US dollars (2%); member's own currency (18%) and the balance 80% was kept as reserve, to be contributed whenever called upon. Thus, only 20% of each member-country's contribution to the capital was available to the Bank for lending purposes, while the balance 80% served as guarantee resource to back the Bank's borrowings in the international markets. The capital has been enhanced periodically and at present stands at $ 170 billion.

Financial Schemes : The World Bank provides financial assistance mostly in the form of direct loans or guarantees. The assistance is provided for productive purposes such as agriculture and rural development, power, industry and transport projects. The World Bank grants loans having a repayment period of 10 to 35 years. These loans are made to the Governments of member countries or are guaranteed by the Government concerned. The rate of interest charged by the Bank is the estimated cost to the Bank, of borrowed money of comparable maturity period from the market. Besides this, the Bank charges commission @ 1% for the purpose of creating a special reserve against loss and 0.5% for covering the administrative expenses.

Besides the lending activities, the Bank also provides technical assistance in undertaking a full-scale economic survey of the developmental potential of member country and provides technical advice on the assisted projects. India has been the single largest borrower of finance from the World Bank.

14.2.3 International Finance Corporation (IFC)

The International Finance Corporation (IFC) is an affiliate of the World Bank. Only the members of the World Bank can become its members. As the World Bank can provide only loan funds and is not allowed to participate in the equity of a project, IFC was established in 1956 with the mandate to provide equity funds also to the private enterprises.

Functions : IFC encourages development of the private sector in the member-countries. Its main functions are :

i) to invest in the private sector of the member countries, in association with private investors and without Government guarantee, in case where sufficient private capital is not available on reasonable terms;

ii) to provide investment opportunities—both foreign and domestic, and experienced management, and

iii) to stimulate conditions conducive to the flow of private capital—both foreign and domestic, into productive investments in member countries.

Organisational Structure : Being an affiliate of the World Bank, the Board of Governors of the World Bank is also the Board of Governors of the IFC. Further, the Executive Directors of the World Bank constitute the Board of Directors of IFC, which is responsible for the operations of IFC. The day-to-day operations are conducted under the superintendence of the Executive Vice-President.

Resources : The resources of the IFC consists of the capital

contributed by the members and the accumulated reserves. It can also borrow resources from the World Bank upto four times of its net worth.

Financing Schemes : IFC provides long-term loans or invests in the equity capital of a wide variety of productive private enterprises in the developing countries. The project assisted should be economically viable and beneficial to the economy of the member country. The minimum quantum of financial assistance provided by IFC is US $ 1 million and the maximum is US $ 100 million. Further, IFC's assistance usually does not exceed 50% of the total investment in a project.

Besides direct lending and equity investment, IFC also provides developmental services such as: identification and promotion of projects, promotion and establishment of privately owned developmental finance companies, encouragement of the growth of capital markets and advisory/ technical counsel on measures that will create a climate conducive for the growth of private sector.

14.2.4 International Development Association (IDA)

International Development Association (IDA) is another affiliate of the World Bank and is also referred to as the "soft loan window" of the World Bank. It provides "soft loans" for economically sound projects of social importance to the member countries. The projects funded by IDA typically include projects like construction of roads, bridges, slum dwellings, etc. Such projects fall under the category of "high development priority" due to the impact of their benefit on the development of the area concerned, but the returns from the projects are not sufficient to pay the high rates of interest on borrowings. The IDA provides loans for such projects free of interest. These loans have longer maturity periods.

Functions and Financial Assistance : IDA extends financial assistance to high priority projects in the member countries. The finance may be made available to the member Governments or to the private enterprises. Advances to private enterprises may be made without government guarantees. IDA also co-operates with other international institutions and member countries in providing financial and technical assistance to the less developed countries. Salient features of the financial assistance provided by IDA are as follows :

i) The financial assistance provided by IDA is interest free. IDA charges a small service charge @ 0.75% p.a. on the amount withdrawn, so as to cover the administrative expenses,

ii) Repayment period is usually over 50 years with an initial moratorium of 10 years,

iii) IDA finances not only the foreign exchange component but also the domestic cost, and

iv) The assistance can also be repaid in the local currency of the borrowing country.

Organisational Structure

All member countries of the World Bank are eligible to become the member of the IDA. As in the case of IFC, the Board of Governors and Executive Directors of the World Bank are also the Board of Governors and Executive Directors of the IDA.

14.2.5 Asian Development Bank (ADB)

Asian Development Bank (ADB) was started in 1966 under the aegis of the United Nations Economic Commission for Asia and Far East (ECAFE). Its membership consists of countries of the Asian region and other regions as well. Presently, there are 47 members out of which 32 countries are from the Asia-Pacific region while 15 countries are from Europe and North America.

Functions : The main objectives and functions of ADB are –

i) To promote investment in the ECAFE region of public and private capital for development purposes,

ii) To utilise the available resources for financing development, giving priority to those regional and sub-regional as well as national projects and programmes which will contribute most effectively to the harmonious economic growth of the region as a whole, and having special regard to the needs of the smaller or less developed member countries in the region,

iii) To meet the requests of members in the region to assist them in co-ordination of their development policies and plans so as to achieve better utilisations of their resources making their economies more complementary and promoting the orderly expansion of their foreign trade, in particular, intra regional trade,

iv) To provide technical assistance for preparation, financing and execution of development projects and programmes, including the formulation of specific proposals,

v) To co-operate with the United Nations, its organs and subsidiary bodies, in particular ECAFE and with public international organizations and other international institutions as well as national entities whether public or

private, and to interest such institutions and entities in new opportunities for investment and assistance, and

vi) To undertake such other activities and to provide such other services as may advance its purposes.

Organisational Structure : ADB's highest policy-making body is the Board of Governors. The Board of Governors consists of 12 Directors out of which 8 represents regional countries and 4 represent non-regional countries. The President of the Bank is elected by the Board of Governors and is also the Chairman of the Board of Governors.

Resources and Financial Assistance : The financial resources of the Bank consist of equity capital comprising of subscribed capital and reserves. Besides equity funds, ADB also has access to funds raised through borrowings and Special Funds comprising of contributions from member countries and amounts previously set aside from the paid-up capital.

ADB provides loans out of the equity funds generally to the member countries, which have attained a somewhat higher level of economic development. Loans from the Special Funds are disbursed exclusively to the poorest borrowing countries at highly concessional rates of interests.

Check Your Progress 1

1) What are SDRs? How are they created?

....

....

....

....

2) True/False :

a) ADB funds projects only in the Asian Region. (True/False)

b) IDA is also referred to as the "Soft Loan Window" (True/False)

c) IFC provides financial assistance to projects in the government sector. (True/False)

d) IMF depends entirely on its equity capital for it's lending operations. (True/False)

e) IMF assists its member to tide over their balance of payments problems. (True/False)

3) Explain the type of financial assistance provided by International Finance Corporation.

....

....

....

14.3 EUROPEAN MONETARY SYSTEM (EMS)

As a first step towards the economic unification of Europe, a treaty was signed in 1951, under which the European Coal and Steel Community (ECSC) was formed. In 1957, the Treaty of Rome was signed and the European Economic Community (EEC) came into existence. The main objective of the EEC was to facilitate an unfettered movement of goods, capital and manpower. As more countries joined, it was decided to establish a European Monetary System. Finally, with the signing of the Maastricht Treaty in 1992, the EEC was renamed as the European Union (EU) and the way was opened for setting up of institutions leading to the establishment of the European Monetary Union (EMU).

The objectives of European Monetary System : The primary objective of the EMS, is to provide and enhance monetary stability in the European Community. Its objectives include working towards the improvement in general and economic situation of the countries of the EU in terms of growth, full employment, standard of living, and reduction in regional disparities. It also aims at brining about a stabilising effect on international economic and monetary relations.

The key feature of the EMS is the Exchange-Rate Mechanism (ERM), which links the currencies to one another. EMS's long-term goal is monetary unification leading to a single currency called the European Currency Unit (ECU). The EMS is one of the facets towards the economic unification in Europe. Various steps have been taken to achieve this end. **As a first step**, border controls, which are used to enforce national quantitative restrictions that restrain imports from the rest of the world, have been abolished. The intention is to convert these restrictions into Community-wide restrictions. The **second step** is the elimination of technical barriers to trade by mutual recognition of most barriers and harmonisation of others such as health, safety, and environmental regulations. The principle of mutual recognition implies that products legally marketed in one Member State can circulate freely throughout the EC. The **third step** is the opening up of the public procurment in four areas not already covered by existing international trade agreements—telecommunications, transportations, energy and water supply.

European Currency Unit : The European Currency Unit (ECU) is central to the EMS. It is a basket of various currencies of the EU weighted according to the economic strength of each one of them. The quantities of each currency

in ECU stay the same while exchange rate fluctuate, as a result of these fluctuations, the values and, therefore, the weightage of the various currencies may change. However, reconstitution or revision of the basket of currencies takes place, usually after every five years.

The composition of the ECU as of June 1991 is given below:

Table 14.1 : Composition of the ECU (as of June 1991)

Currency	Fixed amount of Currency in the ECU	Weight (%)
Deutschmarks	0.6242	30.2
French franc	1.332	19.0
Pound sterling	0.08784	12.5
Dutch guilder	0.2198	9.5
Belgian franc	3.301	7.8
Spanish peseta	6.885	5.3
Danish kroner	0.1976	2.5
Irish pound	0.008552	1.1
Greek drachma	1.440	1.1
Portuguese escudo	1.393	0.8
Italian lira	151.8	9.9
Luxembourg franc	0.13	0.3

14.4 EURO MARKET

During the 1950s, the erstwhile USSR was earning dollars from the sale of gold and other commodities, which was to be used to purchase grains and other items from the West. USSR did not want to keep the sale proceeds in the US banks, as it feared that the US government might freeze the deposits, in case the cold war intensified. Hence, they approached banks in UK and France who accepted these dollar deposits and invested them partly in the US. Thus, originated the concept of **"Eurodollars"**.

A Eurodollar deposit is a deposit in the relevant currency with a bank outside the home country of that currency. Thus, a US dollar deposit with a bank in Paris is a Euro dollar deposit as is a Deutschmark deposit by a US company with the Geneva subsidiary of a US bank will still be called a Eurodollar deposit.

The real impetus in the growth of Euro dollar market came from the US itself in the form of Regulation Q of the Federal Reserve Act, which put a ceiling on the interest rates that

could be paid on bank deposits. Under the regulation, no interest was payable on bank deposits of less than 30 days' tenure, while interest rates for longer tenure were governed by strict ceilings. Thus, on one hand, the interest rates payable on dollar deposits in the US were restricted. On the other hand, there was no such restriction on deposits outside the US. The banks, outside the US, were able to attract substantial dollar funds by offering higher interest rates than prevailing in the US. Further Regulation M of the Federal Reserve Act, encouraged the flow of dollar deposits from the US. Under this regulation, banks were required to maintain certain percentage as reserves against the dollar deposits. This regulation was not applicable to the deposits held by the European branches of the US banks. This made the cost of funds of the US branches higher as compared to the outside branches, which were able to pass on their saving in lower funds cost to their customers. All these factors encouraged the flow of funds from the US to branches outside the US.

Euro-currency market is a highly competitive market with free access for new institutions in the market. Consequently, the margin between the rate of interest on the deposits and the advances has narrowed down considerably. The transactions in the market involve large sums of money, which has led to syndication of loans where a number of banks participate in a lending programme. A special feature of the Euro-currency market is the "floating rates of interest" under which the rates are linked to a base rate such as the London Inter-Bank Offered Rate (LIBOR). The interest rates on the deposits or advances are reviewed periodically in accordance with the LIBOR. The Euro currency market can broadly be divided into 4 segments as follows :

- Euro-credit market where the International banks lend funds on a long to medium-term basis,
- Euro-bond market where the banks raise funds on behalf of international borrowers,
- Euro-currency deposit/market where banks accept deposits usually on short-term basis, and
- Euro notes market where large corporations borrow funds.

14.5 INDIA AND FOREIGN CURRENCY FINANCE

Indian corporates regularly import capital equipments and critical raw materials. To make the payment for the same, they need foreign currencies. Indian industry has been largely dependent on the All-India Financial Institutions for their requirements of foreign currencies. These financial institutions provide foreign currency loans not only for

meeting the cost of plant and machinery, but also the foreign technical know-how fees as well.

These financial institutions, in turn, raise resources in the international financial markets and from multi-lateral financial institutions. Apart from the above, there are other sources of raising long/medium term foreign currency finance for Indian companies which are discussed below :

14.5.1 External Commercial Borrowings (ECBs)

The Government of India now permits Indian companies to raise finance for expansion of existing capacity and fresh investments through External Commercial Borrowings. As per the guidelines issued by the Government of India, companies are free to raise ECBs from any internationally recognised source such as banks, export credit agencies, suppliers of equipments, foreign collaborators, and international capital markets. The salient features of the ECB guidelines as revised from time to time are as follows :

i) **Average Maturity Period** : For ECBs less than USD 20 million equivalent, the minimum average maturity is three years. For ECBs of more than USD 20 million equivalent, the minimum average period is five years. However, 100% Export Oriented Units, are permitted to raise ECBs with minimum average maturity of three years for any amount.

ii) **Quantum of ECBs** : All infrastructure and Greenfield projects are permitted to raise ECBs to the extent of 35% of the total project cost. In case of power projects, more flexibility is allowed based on the merits of each case.

iii) **Rate of Interest** : ECBs can be raised at interest rate upto 1 or 2% points over LIBOR depending upon the credit worthiness of the borrower.

iv) **End-use of ECBs** : ECBs are to be utilised for meeting the foreign exchange costs of capital goods and services. In case of Infrastructure projects such as Power, Telecom, Roads, Ports, Industrial Parks and Urban Infrastructure, proceeds of ECBs can be used for meeting the project related rupee expenditure. ECBs by corporate borrowers can be used to acquire ships/vessels from Indian shipyards. However, under no circumstances, ECB proceeds can be utilised for investments in real estate and speculation in stock market.

v) **Security** : The choice of security to be given to the lender is to be decided by the borrower company. However, in case the security is in the form of guarantee from an Indian Financial Institution or Bank, no counter guarantee or confirmation of the guarantee by a Foreign Bank/Financial Institution is permitted.

The aim of the Government policy regarding External Commercial borrowings is to provide flexibility in borrowings by Indian Corporates and public sector undertakings. At the same time, a safe limit for total external borrowings consistent with provident debt management is to be maintained. The guiding principles for ECB policy are :

i) To keep maturities long,

ii) Low cost, and

iii) Encourage infrastructure and export sector financing.

Every year an ECB cap is fixed keeping in view the requirements of different sectors and medium-term balance of payment projections. The debt service ratio is kept within limit.

Approvals given for External Commercial Borrowing during the last 3 years have been as follows :

1998-99 : US $ million 5,200

1999-00 : US $ million 3,398

2000-01 : US $ million 2,837

Gross disbursement of external commercial borrowings (excluding funds raised through India Millennium Deposits of US $ 5.51 billions) amounted to US $ 3.81 billion in 2000-01. The increase over the previous year was mainly on account of re-financing of pre-payment of more expensive loans with relatively softer terms.

14.5.2 Euro-issues

Consequent to the economic liberalisation programme initiated since the 1990s, Indian corporates have been frequently accessing the international capital markets through the issue of bonds and euro-equities collectively called the "Euro-issues". There are principally two mechanisms— **Depository Receipts**, which represents the indirect equity investments and the **Euro-convertible Bonds**, which are debt instruments with an option to convert into equity.

In the Depository Receipts mechanism, the shares issued by the company are held by a depository, which in turn, issues claims against these shares. These claims are called the Depository Receipts. Each receipt has a claim on a specified number of shares. The underlying shares are called the depository shares. The depository receipts are denominated in a convertible currency, usually dollars and are generally listed and traded on major stock exchanges. The Issuer Company pays dividends to the depository in the home currency, which is converted into dollars by the

depository and distributed, to the depository receipt holders. Through the mechanism of the Depository receipts, the Issuer Company is able to avoid the payment of listing fees and also the disclosure and reporting requirements of the international stock exchanges. Such depository receipts when issued to investors in the US are called the American Depository Receipts (ADRs). However, there has been emergence of European Depository Receipts (EDRs) and the Global Depository Receipts (GDRs).

The Government of India permitted Indian Companies to issue GDR's in 1992 and issued guidelines as follows:

i) An Indian company planning to raise funds through the GDRs has first to obtain permission from the Foreign Investment Promotion Board (FIPB) Deptt. of Economic Affairs, Govt. of India.

ii) **End-use restriction** : GDR issues are permitted only for the following end-use to be incurred within one-year from the date of issue :

   a) Financing import of capital goods;

   b) Financing domestic purchase/installation of plant, equipment and building;

   c) Pre-payment or scheduled payment of earlier external borrowings;

   d) Making investments abroad where these have been approved by competent authorities;

   e) Equity investment in Joint Ventures and Wholly owned subsidiaries in India;

   f) Corporate restructuring, up to a maximum of 25% of the issues proceeds.

iii) **Eligibility** : Only companies having consistent track record of good performance (financial and otherwise) for a minimum period of three years are allowed to issue GDRs. However, in case of infrastructure projects, this condition is relaxed.

iv) Banks, Financial Institutions and Non-Banking Finance Companies (NBFCs) registered with RBI are exempted from the end-use restriction provided that they do not invest the proceeds of the issue in real-estate and stock markets.

v) All India Financial Institutions are also exempted from the end-use restrictions considering the multiplier effect and beneficial impact on the small-scale and medium industries since they cannot access these markets on their own.

vi) There is no restriction on the number of issues, which a company or a group of companies may float, in a financial year.

vii) The company shall be required to specify the proposed end uses of the issue proceeds at the time of making their application, and will be required to submit quarterly statement of utilisation of funds for the approved end-uses, duly certified by their auditors.

Check Your Progress 2

1) What do you understand by External Commercial Borrowings?

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2) Name the various segments of Euro currency market.

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3) Which companies are authorised to issue GDRs.

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14.5.3 Foreign Direct Investments

Since the Government of India permitted the flow of foreign investments in India in 1992, there has been a rising trend in the inflow of such investments. Foreign investments fall in two broad categories : (1) Direct Investment and (2) Portfolio Investment.

Foreign Direct Investments may be held by a person resident outside India (except Bangladesh, Pakistan or Sri Lanka). It can be by way of equity preferences/convertible preferences shares and convertible debentures issued by an Indian Company within prescribed limits. According to the Government's policy direct foreign investments are permitted in certain sectors through automatic route (i.e. no permission is required). In some other sectors, there are sectoral limits prescribed. In the remaining cases, prior approval of Secretariat for Industrial Assistance (SIA) or of Foreign investment Promotion Board (FIPB) of the Government of India is required. The terms and conditions prescribed by these authorities are to be complied with. Foreign Investments are allowed upto 100% in certain deserving sectors, e.g. exports. As is evident from the Table 14.1 given

below investment through FIPB/SIA route accounted for the bulk of foreign direct investment during 2000-01.

14.5.4 Portfolio Investments

Under the Portfolio Investment Scheme, foreign institutional investors (FII) registered with Securities and Exchange Board of India are permitted by the Reserve Bank of India to purchase shares and convertible debentures of Indian companies through registered brokers at recognised Stock Exchanges in India. These institutions are permitted to invest in India within certain limits only, e.g. each FII can invest upto 10% of total paid up capital of the Indian company or 10% of the paid up value of each convertible debentures issues by an Indian company. Total holding of all FIIs together shall not exceed 24% of the paid up equity capital or paid up value of each series of convertible debentures. The aggregate limit of all FIIs, may be increased to 49% with the approval of the general body of shareholders. Purchase through private placement/arrangement is also permitted, subject to the above ceilings. Recently, FIIs have also been permitted portfolio investment through Secondary market up to the applicable sectoral levels of the issued and paid up capital of the company.

Portfolio investment is also permitted for Non-Resident Indians and Overseas Corporate Bodies on a recognised Stock Exchange in India on repatriation or non-repatriation basis, through a registered broker. But each NRI is permitted to hold such shares up to 5% of the paid up value of shares issued by the Indian Company/paid up value of each series of convertible debentures. Aggregate paid up value of shares of all NRIs/OCBs should not exceed 10% of the paid-up value of equity shares/each series of debentures. This limit may be raised to 24% by a special resolution at the General Body Meeting.

Table 14.2 : Foreign Direct Investment in India (US $ Million)

	1991-92	2000-01
A. Direct Investment	129	2339
(a) RBI Automatic route	--	454
(b) SIA/FIPB route	66	1456
(c) NRIs (40% & 100%)	63	67
(d) Acquisition of Shares *	-	362
B. Portfolio Investment	4	2760
(a) Foreign International Investor	--	1847
(b) GDRs/ADRs	--	831
(c) Offshore funds/others	4	82
Total A & B	**133**	**5099**

Source: Economic Survey 2000-01

* Related to acquisition of shares of Indian Companies by NRIs under section 5 of FEMA.

14.5.5 Non-Resident Indians' Deposits

Another source of foreign currency finance is the deposits made in Indian Banks by Non-Resident Indians. Reserve Bank of India has permitted the banks to open mainly three types of deposit accounts in the names of non-resident Indians. These accounts are held in Indian rupees as well as in four major foreign currencies. Under the Foreign Currency Non-Resident (Banks) scheme {FCNR (B)}, deposits are accepted in dollars, pounds, yen and Euro and they are repatriable in the foreign currency also. Under non-resident External Rupee Accounts (NRERA), accounts are accepted in rupee, which are repatriable in foreign currency but at the prevailing rate of exchange. Non-resident (Non-Repatriable) Rupee Deposits Scheme (NRNRRD) does not provide for repatriation of the deposits made in rupees. Table 14.3 shows the outstanding balances under these schemes in recent years.

Table 14.3 : Outstanding Balances under NRI Deposit Schemes (US $ million)

Scheme	March		
	1999	2000	2001
FCNR (B)	7835	8172	9076
NRERA	6045	6758	7147
NRN RRD	6618	6754	6849
Total	**20498**	**21684**	**23072**

Source : Economic Survey 2000-01

The above figures are inclusive of accrued interest also. The increasing trend of outstanding balances in these accounts shows the overall confidence of non-resident Indians in the strength of Indian economy.

Check Your Progress 3

1) Fill up in the blanks:

   i) Foreign investment can be put under .... categories.

   ii) Foreign investment is allowed to the extent of .... per cent in export sector.

   iii) Foreign institutional investors are allowed to invest in India upto .... of total paid-up capital of Indian company.

   iv) RBI has permitted banks to open .... types of account in the names of NRIs.

14.6 LET US SUM UP

The Financial System at the global level helps in the transfer of resources across countries. The need for such transfer of resources from one country to another may arise due to international trade in goods and services. The international monetary system, which operated just prior to 1914, was called the "Gold Standared System". Under this system, "gold and sterling" were the two assets, which were accepted in the settlement of international debt and were called the reserve assets. The post-war monetary system was created in 1944 at the Bretton Woods, New Hampshire, USA, where a conference was organised by the representative of the Allied countries to find out a way for an orderly conduct of international trade promote good monetary system. A new institution called the International Monetary Fund (IMF) was set-up to promote consultation and collaboration on international monetary problems and to lend to its member countries in need due to persistent deficit in the balance of payments.

The International Monetary Fund (IMF) is the central institution of the international monetary system as it facilitates the adjustment of balance of payment imbalances. International Bank for Reconstruction and Development (IBRD) or the World Bank provides long-term financial assistance to its member countries for their reconstruction and development. The International Finance Corporation (IFC) is an affiliate of the World Bank which provides equity funds to the private enterprises. International Development Association (IDA) is another affiliate of the World Bank and also referred to as the "soft loan window" of the World Bank as it provides "soft loans" for economically sound projects of social importance to the member countries. Asian Development Bank (ADB) promotes investment in the ECAFE region of public and private capital for development purposes.

The main objective of the EEC was to facilitate an unfettered movement of goods, capital and manpower. As more countries joined, it was decided to establish a European Monetary System. Finally, with the signing of the Maastricht Treaty in 1992, the EEC was renamed as the European Union (EU) and the way was opened for setting up of institutions leading to the establishment of the European Monetary Union (EMU). The primary objective of the EMU is to provide and enhance monetary stability in the European Community. The European Currency Unit (EC) is a basket of various currencies of the EU weighted according to the economic strength of each one of them. A Eurodollar deposit is a deposit in the relevant currency with a bank outside the home country of that currency.

Indian corporates have been largely dependent on the All-

India Financial Institutions for their requirements of foreign currency. Other major sources of raising long/medium-term foreign currency funding for Indian companies are External Commercial Borrowings and Euro Issues.

14.7 KEY WORDS

Eurodollar Deposit is a deposit in the relevant currency with a bank outside the home country of that currency.

Quota is the contribution of the member countries towards the equity capital of the IMF to be originally contributed in the form of gold and the country's own currency. The size of the quota was to be a function of each member's size to the world economy.

Special Drawing Rights (SDRs) is the international reserve asset, which was originally equivalent to a fixed number of dollars. Now, it is a basket of various currencies such as US dollars, German Deutschmarks, Japanese Yen, French Francs and British pound sterling.

Tranches is the process of drawings the SDRs by a member country from the IMF.

14.8 SOME USEFUL BOOKS

Adrian Buckly (1998): *Multinational Finance*, Third Edition, Prentice-Hall of India Private Limited, New Delhi.

Apte P. G. (1998): *International Finance*, Third Edition, Prentice-Hall of India Private Limited, New Delhi.

Giddy Ian H. (1997): *Global Financial Markets*, AITBS Publishers & Distributors, New Delhi

14.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) Special Drawing Right is a basket of various currencies (US $, German Deutschmarks, Japanese Yen, French Francs and British Pond sterling which is equivalent to a fixed number of dollars. It is an instrument of IMF for creation of a new international reserve asset.

2) (a) False (b) True (c) False (d) False (e) True

3) Direct lending, equity investment, providing developmental services.

Check Your Progress 2

1) External Commercial Borrowings refers to raising of long/ medium-term foreign currency finance from any internationally recognised source such as banks, export credit agencies, foreign collaborators etc.

2) Euro credit market, Euro bond market, Euro currency deposit/market, Euro notes market.

3) The companies having consistent track record of good performance for a minimum period of 3 years.

Check Your Progress 3

1) (i) two (ii) 100 per cent (iii) 3-10 per cent (iv) three

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